NOTE

PREVENTING CONTROL FROM THE GRAVE: A PROPOSAL FOR JUDICIAL TREATMENT OF DEAD HAND PROVISIONS IN POISON PILLS

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INTRODUCTION

Ever since the merger and acquisition boom of the 1980s, companies have sought increasingly more powerful means to protect themselves from the unsolicited[1] tender offers of raiders.[2] Among the most potent of these defenses has been the shareholder rights plan—more commonly known as the poison pill.[3] Initially, rights plans successfully defended target companies against raiders' naked tender offers. But the raiders enhanced their tactics, and today, their method for gaining control usually involves commencing a tender offer in combination with a proxy or consent solicitation.[4] Faced with this new threat, targets in turn fortified

1. "Unsolicited" refers to those takeovers initiated by the acquiring company against the will of the target company's board, as opposed to "friendly" or "uncontested" takeovers in which the target company's board agrees to be purchased by the acquiring company. See Robert A. Prentice, Front-End Loaded, Two-Tiered Tender Offers, 39 Case W. Res. L. Rev. 389, 393 (1988–89); Charles M. Yablon, Poison Pills and Litigation Uncertainty, 1989 Duke L.J. 54, 54.

2. See 1 Arthur Fleischer, Jr. & Alexander R. Sussman, Takeover Defense § 5.04[A], at 5-37 (5th ed. 1995) (describing target companies' earnest searches for effective deterrents to hostile takeovers).

3. See 1 id. § 5.04[B], at 5-38. Vulnerable companies first implemented "packages of internal 'structural' changes, or 'shark repellants,' which were designed to make it more difficult for a raider to displace the incumbent board or acquire the company through a coercive tender offer." 1 id. § 5.04[A], at 5-37. These devices, however, suffered from the drawback of requiring shareholder approval for their implementation. See id. In shareholder rights plans, target boards found "a measure that [could] be implemented, without stockholder approval, to enable the board to interpose itself as a buffer to protect the company and its stockholders against the omnipresent spectre of [takeover attacks]." 1 id. § 5.04[B], at 5-38.

4. See Steven Lipin, More Potent Weapons Dwell in Takeover Arsenal, Wall St. J., Sept. 7, 1995, at C1 [hereinafter Lipin, Weapons] ("The joining of proxy or consent solicitations with takeover bids is almost standard operating procedure now. . . . As a tactical matter, if you're prepared to make an unfriendly bid, you use all the tools at your command, and [this tactic is] a very important one." (quoting Peter Atkins)). The use of proxy contests to unseat incumbent directors has increased during the past few years. See Georgeson & Co., Corporate Governance: 1995 Annual Meeting Season Wrap-Up 15 fig. 14 (1996).

Shareholders of many corporations frequently also use consent solicitations to elect and replace directors and to effect acquisitions. See 2 Ernest L. Folk, III et al., Folk on the Delaware General Corporations Law § 228.1, 228:3 (3d ed. 1992 & Supp. 1996). Consent solicitations are the immediate shareholder vote proscribed in many corporate certificates

their rights plans with "continuing directors" provisions, or "dead hand" provisions, as they are often called in the merger community.[5] These provisions provide effective protection against raiders' control contests.[6] This new protection comes at a high price, however: continuing directors provisions critically infringe shareholder voting rights.

Johnson & Johnson's (J&J) recent unsolicited $1.8 billion bid for Cordis Corporation and Cordis's response thereto exemplify these offensive and defensive tactics.[7] On October 19, 1995, J&J announced an offer of $100 per share of Cordis and expressed its intent to increase its price to $105 if the two companies could reach a friendly agreement on the sale.[8] At the same time, J&J commenced a consent solicitation and sued Cordis in a Florida federal court to force the removal of Cordis's shareholder rights plan.[9] Several days later, Cordis disclosed the terms of its rights plan. It contained a continuing directors provision empowering only the current board or its approved successors to rescind the plan.[10]

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of incorporation or bylaws. See Del. Code Ann. tit. 8, § 228 (1995) (allowing shareholders to act "by written consent" unless such action is explicitly forbidden in the certificate of incorporation). AT&T Corporation employed a consent solicitation in its successful battle for control of NCR Corporation in 1991. In 1995, Lotus Development Corporation, under threat of a consent solicitation, ceded control after only six days to International Business Machines Corporation. See Lipin, Weapons, supra, at C1. One of the benefits of consent solicitations for insurgent shareholders is that the board's ability to regulate the consent procedure is limited. "Under section 228(a), the exercise of the right to act immediately by majority written consent may be modified or eliminated only by the certificate of incorporation. Thus, by-laws that effectively abrogate the exercise of this right are invalid." 2 Folk et al., supra, § 228.5, at 228:9.

5. Continuing directors provisions have been labelled "dead-hand" provisions because "people who are no longer directors . . . are trying to rule from the grave." Steven Lipin, J&J Goes to Court to Disarm Cordis of an Unusual "Pill," Wall St. J., Oct. 27, 1995, at B2 [hereinafter Lipin, Court]; see Steven Lipin, Big B's Unusual Poison Pill Sparks Lawsuit by Hostile Suitor Revco, Wall St. J., Oct. 1, 1996, at B4 [hereinafter Lipin, Revco].

6. Such provisions function by permitting only incumbent directors or their handpicked successors to redeem or remove the shareholder rights plan, even if incumbent directors are replaced in a voting contest. See Lipin, Revco, supra note 5, at B4; Lipin, Court, supra note 5, at B2; infra Part I.C. For an example of a company that enacted a continuing directors provision to defend against a takeover attempt involving a joint tender offer and consent solicitation, see infra note 10.

7. J&J, until utilizing this tactic, had a sterling reputation as an amiable corporate player. Its motivation for this acquisition stemmed from its desire to enhance its own cardiac product line, including its coronary-stent operations, by incorporating Cordis's angioplasty and other products related to medical treatment of heart problems. See Ron Winslow & Steven Lipin, Heard on the Street: Some Traders Point to a Former Cordis Unit as Reason for J&J Putting Brakes on Talks, Wall St. J., Jan. 5, 1996, at C2.

8. See Steven Lipin, J&J Files Bid to Oust Board of Cordis Corp., Wall St. J., Oct. 23, 1995, at A3 [hereinafter Lipin, J&J Files].

9. See id.; Lipin, Court, supra note 5, at B2.

10. Cordis adopted its shareholder rights plan earlier in October, presumably after Cordis rebuffed J&J's attempt to discuss a friendly merger. See Lipin, Court, supra note 5, at B2. Because J&J employed the consent solicitation, which was a tactical weakness in Cordis's ability to defend against a takeover, Cordis adopted the continuing directors provision to fortify its limited defensive capacity. See id.

Even if J&J were successful in replacing the existing board through the consent solicitation, the new board would be unable to remove the plan under the terms of this provision.[11] In response, J&J amended its lawsuit on October 26 to request that enforcement of Cordis's plan be enjoined.[12] On November 6, before the suit was adjudicated, J&J and Cordis reached an agreement allowing J&J to purchase the company for $109 per share.[13] The lawsuit was subsequently dropped.

Had this litigation reached trial, the decision would have carried significant implications for corporate jurisprudence regarding the validity of continuing directors provisions. The result would have been the first judicial pronouncement on the subject since *Bank of New York Co. v. Irving Bank Corp.*, in which a New York state court struck down a continuing directors provision on the ground that it violated New York corporate law by restricting the power of the board of directors without the placement of such restrictions in the certificate of incorporation.[14] Because the *Bank of New York* court enjoined enforcement of the provision on statutory grounds, it did not reach the issue of infringement of shareholder sovereignty or the related issues of the board's fiduciary duties or mitigating directorial justifications for the adoption and implementation of continuing directors provisions. These issues are likely to govern future judicial resolution of the validity of continuing directors provisions and thus merit further examination.

This Note argues that continuing directors provisions in shareholder rights plans should be found invalid per se on the ground that they serve no purpose but to entrench management and consequently infringe shareholder sovereignty. Part I examines how continuing directors provisions in poison pills negatively affect voting rights. Part II reviews corporate jurisprudence addressing the importance of the shareholder electoral franchise and the validity of shareholder rights plans and continuing directors provisions in light thereof. Part III argues that, under the standards that courts have established to scrutinize defensive mechanisms generally, continuing directors provisions are inconsistent with boards' fiduciary duties to shareholders and should be invalidated. This conclusion is reinforced by the availability of other protective measures that provide similar protection without negative repercussions on shareholder voting rights.

11. See id.; infra text accompanying notes 79–88 for an explanation of the terms and characteristics of a continuing directors provision.

12. See Lipin, Court, supra note 5, at B2.

13. See Winslow & Lipin, supra note 7, at C2.

14. See 528 N.Y.S.2d 482, 485 (Sup. Ct. 1988). For a summary of this decision and its holding, see infra notes 144–149 and accompanying text.

I. The Effect of Continuing Directors Provisions on the Shareholder Electoral Franchise During Unsolicited Takeover Contests

The battle for corporate control is fought using sophisticated strategies that have evolved dramatically over the past two decades. These strategies are not without controversy. Modern defensive manuevers, in particular, have recently been subjected to criticism on various grounds. While such techniques may be justified as a shield to protect shareholders against inadequate tender offers, they may also be criticized for their disenfranchising effects.

A. *Unsolicited Takeover and Defense Tactics*

As merger activity increases,[15] so does the use of defenses against unsolicited control threats.[16] Companies that are the targets of unsolicited takeovers rely on an array of colorfully-named protective devices, including "shark repellants," "lock-up options," "cyanide capsules," "Pac-Man" counter-bids and sales of "crown jewels."[17] But one of a target com-

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15. The value of assets exchanged in 1995's merger and acquisition activity totalled an unprecedented $458 billion, surpassing the previous record of $347 billion in 1994. See Steven Lipin, Let's Do It: Disney to Diapers Makers Push Mergers and Acquisitions to Record High, Wall St. J., Jan. 2, 1996, at R8. Some of 1995's most expensive transactions include Walt Disney Company's pact to buy Capital Cities/ABC, Inc. for $19 billion, Chemical Banking Corporation's agreement to merge with Chase Manhattan Corporation for $10 billion, and Kimberly-Clark Corporation's promise to purchase Scott Paper Company for $7 billion. See id. These mergers were effected primarily through two means. As in the 1960s, the booming stock market of 1995 and 1996 encouraged many stock acquisitions. See id. Also, low interest rates facilitated strategic cash transactions. See Robin Sidel, Record Clip of Mergers Called Just a Prelude, San Diego Union & Trib., Dec. 26, 1995, at D1. The level of merger and acquisition activity reached in 1995 is expected to increase even further during 1996. See Charles v. Bagli, MCI Deal Would Speed Pace of Current Mergers, N.Y. Times, Nov. 2, 1996, at 37.

16. It is anticipated that more companies will implement poison pills as a result of the increased merger activity. One commentator persuasively predicted that "pill activity may increase (1) as rights plans adopted in the mid-1980s reach their 10-year expiration dates, and (2) if takeover activity, which rose markedly in 1993, becomes even more prevalent." 1 Fleischer & Sussman, supra note 2, § 5.01[A], at 5-5 n.4. However, the pace at which pills have been adopted into corporations' bylaws has slowed since the late 1980s. Corporations implemented 328 new pills in 1989, 177 in 1990, 82 in 1991, 47 in 1992 and 31 in 1993. See 1 id. The fact that—in actual numbers—fewer pills have been adopted does not undermine the commentator's conjecture. Several factors may explain this decline. First, by the beginning of 1994, over 1375 companies had adopted poison pills, so "most companies in need of [the] poison pill [had] already adopted a plan." 1 id. Second, until early 1994, the number of unsolicited takeover contests in the 1990s was limited, as compared to the late 1980s. See 1 id.

17. See 1 Martin Lipton & Erica H. Steinberger, Takeovers & Freezeouts §§ 6.03[1]–6.03[3], at 6-28 to 6-57, 6.06[4][k], at 6-238, 6.06[5][a], at 6-239 to 6-241, 6.06[3], at 6-128 to 6-129 (1995).

The permissibility of defensive mechanisms in the face of unsolicited takeover contests is an exceptionally contentious issue. The views on this subject take two polar positions. Proponents of defensive devices list a number of factors that lead to the conclusion that

pany's most potent weapons in its defensive arsenal remains the shareholder rights plan,[18] popularly known as the "poison pill."[19] Rights plans, which arose during the 1980s in response to that period's heavy volume of hostile takeover activity, were designed to impede bidders seeking to acquire substantial shareholdings directly from a target's shareholders without first obtaining approval from the target's board of directors.[20]

Shareholder rights plans typically involve the issuance to shareholders of a dividend granting one stock purchase right per share of common stock. Until an acquiror passes a certain threshold of stock ownership, generally fifteen to twenty percent of the target's outstanding voting stock, the rights are economically valueless.[21] But once the threshold has

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hostile takeovers are undesirable. They contend that such contests "make managers of companies that are potential targets of takeover bids worry too much about short-term financial results and that [takeovers] promote absentee ownership and control." Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 253 (7th Cir. 1986), rev'd on other grounds, 481 U.S. 69 (1987); see, e.g., Gerald F. Davis, Agents Without Principles? The Spread of the Poison Pill Through the Intercorporate Network, 36 Admin. Sci. Q. 583, 609 (1991) (concluding that "managerial control is [not] sharply constrained by capital markets"); F. M. Scherer, Takeovers: Present and Future Dangers, Brookings Rev., Winter/Spring 1986, at 15 (examining economic implications of 1980s takeover wave). For this reason, defensive maneuvers may be justified in light of the harmful effects of tender offers.

On the other hand, opponents set forth reasons why all resistance to hostile takeovers is undesirable. See, e.g., A Study on the Economics of Poison Pills, [1985–1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,971 (Mar. 5, 1986) (suggesting that adoption of poison pills decreases stock prices); Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981) (arguing that resistance ultimately reduces shareholder welfare); Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819 (1981) (arguing that management's ability to resist tender offers should be limited). They support the contention that the "[m]arket price of publicly traded stock impounds all available information about the value of the stock, and anyone who offers a higher price . . . thereby offers an unequivocal benefit to the shareholders of the target firm, which management if it is really a fiduciary of the shareholders should embrace rather than oppose." *CTS Corp.*, 794 F.2d at 253. According to this view, prohibition of defensive devices will create an environment where "corporate control will be kept fluid and corporate assets will be transferred, with a minimum of friction, to those who value them the most, as measured by the prices they offer." Id.

18. See 1 Fleischer & Sussman, supra note 2, § 5.01[A], at 5-5.

19. See 1 Lipton & Steinberger, supra note 17, § 6.03[4], at 6-57.

20. See 1 id. § 6.03[4][a], at 6-59; Yablon, supra note 1, at 55.

21. 1 Fleischer & Sussman, supra note 2, § 5.01[B][1], at 5-6, provide the following description of the poison pill:

> [T]he term "poison pill" denotes a distribution to stockholders of a right which acquires significant economic value upon the occurrence of specified events involving a non-board-approved acquisition of a significant ownership position in the company. Since this economic value consists of an entitlement to receive money or property from the company or the raider, and the acquisition cannot be consummated without triggering this entitlement, the raider cannot swallow up the company without also ingesting the economic poison represented by the value that has to be delivered upon exercise of the rights.

The following summarizes the terms of a shareholder rights plan implemented by Apple Bancorp in November 1989:

been crossed, the pill is triggered, an event that can be harmful to the acquiror's interests as shareholders are entitled to exercise these rights. The benefits to which the rights entitle shareholders depend on the type of pill that was triggered.

Poison pills take three primary forms.[22] The first and currently most prevalent form, known as a "flip-in" plan, is triggered when the acquiror crosses the ownership threshold, regardless of the acquiror's intentions with respect to the use of the shares. At that time, rights vest in all shareholders other than the acquiror. These rights-holders are then entitled to acquire additional shares of voting stock at a substantially discounted price, usually at around fifty percent of the market rate.[23] The second form is the "flip-over" plan. Pursuant to this plan, target shareholders can purchase shares of the acquiring company in quantities equal to the amount held by them in the target company.[24] Furthermore, similar to the flip-in plan, the acquiring company's shares can be purchased at a much-reduced price.[25] This plan is activated when, after a flip-in event, the acquiror initiates a proscribed event, such as a merger, self-dealing

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> [T]he Board of Directors adopted a Shareholder Rights Plan and declared a dividend of one preferred share purchase right ("Right") for each outstanding share of common stock of Bancorp. Each right will enable the holder thereof to buy a one-hundredth interest in a share of a new series of preferred stock of Bancorp at an exercise price of $1.35. Initially, the rights will not be exercisable and will transfer with and only with the shares of common stock. The rights will be exercisable and separately transferable twenty business days after a person or group of persons acquires generally 15% or more of Bancorp's common stock, or twenty business days, or such later date as may be determined by the Board of Directors, after a person or group announces a tender offer the consummation of which would result in ownership by a person or group of persons of generally 15% or more of the common stock.
>
> If a person or group of persons becomes an Acquiring Person, otherwise than pursuant to a cash tender offer for all shares in which such person or group increases its stake to 80% or more of the outstanding shares of common stock, each Right will entitle its holder (other than such person or members of such group) to purchase, at the then-current purchase price of the Right, a number of shares of common stock of Apple Bancorp, Inc. having a market value twice the purchase price of the Right. Additionally, if Bancorp is acquired in a merger or other business combination transaction, each Right will entitle its holder to purchase, at the then-current purchase price of the Right, a number of shares of common stock of the acquiring company having a market value at that time of twice the purchase price of the Right. Subject to certain limitations, Bancorp's Board of Directors may reduce the 15% threshold, but not to less than 10% . . . .

Randall S. Thomas, Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?, 46 Vand. L. Rev. 503, 510 n.24 (1993) (quoting 1 Moody's Bank and Finance Manual 1602 (1990)).

22. In addition, the term "poison pill" may also be used in a less strict sense to refer to "quasi-pills," other defensive measures that decrease a target's economic attractiveness and thereby reduce its vulnerability to hostile takeovers. See 1 Fleischer & Sussman, supra note 2, § 5.10, at 5-180.

23. See 1 id. § 5.01[B], at 5-7.

24. See 1 id.

25. See 1 id.

transaction or sale of assets.[26] The last form is the "back-end" plan, which entitles shareholders facing a hostile takeover to exchange their shares for a bundle of securities at a favorable exchange rate established by the management.[27]

Plans can be adopted by incumbent management alone, without shareholder approval.[28] At times boards might seek shareholder advisory votes relating to adopting or to amending a plan, but they usually act without regard to shareholder views. This trend has been exacerbated, "particularly in light of *Unocal*'s reaffirmation of the board's activist role in the area of takeover defense generally and *Household*'s unequivocal confirmation of the board's corporate authority to implement a pill."[29] Power to redeem the pill[30] is vested in the board of directors alone, which may redeem the rights at any time upon payment of a nominal amount.[31]

A triggered pill makes completing a tender offer prohibitively expensive and, in the case of a flip-in plan, dilutes the bidder's shareholdings. As a result, pills impede or prevent coercive takeover attempts and allow a target's board of directors to respond to control contests in a methodical and reasoned way.[32] But because this device often pits the interests of a target's incumbent management against those of shareholders by imped-

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26. See 1 id.

27. See 1 id. § 5.04[A], at 5-34. Such securities typically consist of equity or debt instruments of the acquiror.

28. See 1 Lipton & Steinberger, supra note 17, § 6.03[4], at 6-60. This feature makes a shareholder rights plan an effective defense. Because it can be inserted into the target company's bylaws without a shareholder vote, a board can implement it quickly and confidently. See 1 Fleischer & Sussman, supra note 2, § 5.04[B], at 5-38.

29. 1 Fleischer & Sussman, supra note 2, § 5.01[B], at 5-7 to 5-8. The *Unocal* reference in this quotation refers to Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). For discussion of that case, see infra notes 112–116 and accompanying text. The *Household* reference in the quotation refers to Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985). For discussion of that case, see infra notes 101–104 and accompanying text.

30. See 1 Fleischer & Sussman, supra note 2, § 5.01[B], at 5-8. A memorandum by Wachtell, Lipton, Rosen & Katz, the law firm attributed with inventing the shareholder rights plan, describes the process and purpose of redeeming the rights:

> The rights are redeemable by the company's board of directors at a price of $.01 per right at any time prior to the acquisition by a person or group of beneficial ownership of 20% or more of the company's common stock. The redemption of the rights may be made effective at such time on such basis and with such conditions as the board of directors in its sole discretion may establish. Thus, the rights would not interfere with a negotiated merger or a white knight transaction, even after a hostile tender offer has been commenced.

Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 744 (2d ed. 1995) (quoting Wachtell, Lipton, Rosen & Katz, The Share Purchase Rights Plan (1994)).

31. See 1 Fleischer & Sussman, supra note 2, § 5.01[B], at 5-7.

32. See 1 id. § 5.01[A], at 5-5.

ing unsolicited bids,[33] poison pills have been characterized as a tool to entrench management.[34] Early litigants opposing the pill's legality predicted that no one confronting a company armed with a poison pill would ever make a hostile offer.[35]

Despite such apocalyptic forecasts, insurgents enjoy continuing success with hostile tender offers for the many companies that have enacted poison pills. Often raiders succeed because the incumbent directors are ultimately willing to include the redemption of the target company's pill in a takeover contest's negotiated resolution.[36] But even if the board does not agree to redeem the pill, a number of options remain to the raider in its attempt to acquire the target company:

> [There are] many methods around the Plan ranging from tendering with a condition that the Board redeem the Rights, tendering with a high minimum condition of shares and Rights, tendering and soliciting consents to remove the Board and redeem the Rights, to acquiring 50% of the shares and causing [the target company] to self-tender for the Rights. One could also form a group of up to 19.9% [if the target's trigger threshold is 20%] and solicit proxies for consents to remove the Board and redeem the Rights.[37]

As stated above, raiders often utilize these tactics subsequent to negotiation failure.[38]

However, numerous recent developments, including widespread implementation of poison pills by U.S. companies,[39] have enhanced incumbent directors' ability to defeat a bidder's naked tender offer.[40] These

33. See Babatunde M. Animashaun, Poison Pill: Corporate Antitakeover Defensive Plan and the Directors' Responsibilities in Responding to Takeover Bids, 18 S.U. L. Rev. 171, 173 (1991); Gilson, supra note 17, at 819.

34. See Yablon, supra note 1, at 55.

35. See id.

36. See id. at 56. Pills have never entirely precluded the success of a hostile takeover. Rather they function as a "delaying tactic," providing target companies with an opportunity to explore potential moves in a deliberate, unfrenzied manner. See 1 Fleischer & Sussman, supra note 2, § 5.01[A], at 5-5; Yablon, supra note 1, at 56.

37. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985).

38. See supra note 4.

39. See supra note 16.

40. These factors come in legal and financial varieties. The legal factors have strengthened and clarified the authority of boards to defend against hostile takeovers. Such factors include the following:

> judicial reluctance to interfere prematurely with the adoption and maintenance of shareholder rights plans; the confirmation of the primacy of the business judgment of the board of directors by the Delaware Supreme Court in *Paramount Communications, Inc. v. Time, Inc.* . . . ; judicial acceptance . . . of the "white squire" defense and the adoption of employee stock option plans (ESOPs); and the accelerated adoption of and judicial deference to state antitakeover statutes.

Irwin H. Warren & Kevin G. Abrams, Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests, 47 Bus. Law. 647, 647 (1992) (footnotes omitted). From a financial perspective, several factors have made obtaining backing, especially for hostile tender offers, more difficult. These include:

developments, together with the increased involvement of institutional shareholders,[41] have spurred bidders to employ different measures in their efforts to gain control of target companies. During the 1980s, bidders relied primarily on the commencement or threat of a tender offer as a means of gaining control.[42] Today, bidders' tool of choice is the shareholder right to replace incumbents with directors committed to the shareholders' own policy preferences.[43] Bidders are likely to combine a tender offer with a consent solicitation or proxy contest to overcome or weaken incumbents' reluctance to accept the bidder's offer.[44] A bidder's

> financial and regulatory pressures on United States banks and insurance companies, the virtual collapse of the market for new issues of high-yield securities, the unavailability of alternative sources of subordinated financing, . . . changes in the tax laws, the heightening of margin requirements, the risk averse and anti-leverage posture of most money center banks, [and] the emergence of "event risk" covenants in financing agreements . . . .

Id. at 647–48.

41. As the relative percentage of holdings by institutional investors has increased over the past decade, institutional shareholders have more militantly participated in corporate activities. See Affidavit of John C. Coffee, Jr. at ¶ 44, Big B, Inc. v. Revco D.S., Inc. (N.D. Ala. filed 1996) (No. CV-96-H-2496-S) [hereinafter Coffee Affidavit]; Gilson & Black, supra note 30, at 1401; Jeffrey N. Gordon, Shareholder Initiative 60 U. Cin. L. Rev. 347, 347 (1991) (arguing that shareholder "voice" has increased with the rise of institutional ownership and subsequent decline in collective action barriers).

42. See TW Servs., Inc. v. SWT Acquisition Corp., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334 (Del. Ch. Mar. 2, 1989) (discussing fiduciary duties of board of directors in face of a tender offer); 1 Fleischer & Sussman, supra note 2, § 1.01[B], at 1-4 to 1-5.

43. See supra note 4; see also 1 Fleischer & Sussman, supra note 2, § 10.01, at 10-3 ("Corporate America has witnessed an increase in the number of proxy contests in recent years, as economic, legal and political developments have stimulated greater use of the proxy weapon by raiders and dissidents and have made it a key tactical tool in tender offer battles."). Bidders are largely successful in their attempts to take control of target corporations by means of a proxy contest or consent solicitation. See Georgeson & Co., Proxy Contest Study: October 1984 to September 1990, at 5 (1990) ("If we consider contests in which challengers won the vote, together with negotiated settlements during or after the contest and other developments within one year, challengers achieved significant advances toward their objectives or gained other benefits for themselves and other shareholders in 74% of all control contests.").

44. Recently, such combinations have emerged to pressure the target board into not depending "solely on the corporation's shareholder rights plan and a 'just say no' posture" to fend off the bidder. Warren & Abrams, supra note 40, at 650. Such pressure may be necessary, especially when courts support the incumbent board. In *Amanda Acquisition Corp. v. Universal Foods Corp.*, for example, the court rejected the bidder's argument that the board breached its fiduciary duty by "just saying no" to the offer. The board simply refused to negotiate with the bidder for an improved offer or to pursue an alternative transaction such as a "white knight" acquisition ("a third company that the target persuades to merge with it or to make a competing offer that it hopes will lead to a combination more to its liking." Louis Loss, Fundamentals of Securities Regulation 499, 502 (2d ed. 1988)), a management leveraged buy-out or recapitalization. 708 F. Supp. 984, 1013 (E.D. Wis. 1989); see also Joel Seligman, Corporations 1137 (1995) (describing a "just say no defense" as where "the board rejects the bidder's offer as inadequate and does not, for example, redeem or invalidate poison pill rights").

victory in the proxy contest or consent solicitation enables the insurgent to install directors who will rescind or redeem the target's poison pill.[45]

B. *Poison Pills in Tender Offers and Voting Contests*

The results of poison pills used to defend against tender offers differ from the results of pills used to defend against voting contests, such as proxy fights or consent solicitations, that implicate shareholder voting rights.

1. *Tender Offers.* — Although indisputably affording wide leverage to ward off control contests, poison pills may nonetheless be justified on the ground that they prevent coercive action on the part of corporate raiders. Bidders commencing tender offers[46] for target companies' shares have implemented a variety of offensive strategies, which are arguably both coercive and contrary to the interests of shareholders.[47] One of the most controversial techniques takes the form of a two-tiered, front-end loaded tender offer.[48] This method typically involves a bidder's cash offer for a majority of a target's shares. This partial acquisition allows the bidder to gain control, after which the bidder usually gains complete ownership with a freeze-out merger whereupon it acquires the remaining equity.[49]

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45. J&J employed this tactic against Cordis. J&J initiated a consent solicitation for control of Cordis in order to install a board that would be willing to redeem Cordis's poison pill. See supra notes 7–13 and accompanying text.

46. Because neither the Securities and Exchange Commission nor Congress has defined "tender offer," most courts and commentators have relied upon the description set forth in Wellman v. Dickinson, 475 F. Supp. 783, 823–24 (S.D.N.Y. 1979). The *Wellman* court listed eight factors to be considered in identifying a tender offer:

> (1) Active and widespread solicitation of public shareholders for the shares of an issuer; (2) solicitation made for a substantial percentage of the issuer's stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased; (6) offer open only a limited period of time; (7) offeree subject to pressure to sell his stock; and (8) public announcement of a purchasing program concerning the target company precede or accompany rapid accumulation of large amounts of the target company's securities.

Nathaniel B. Smith, Note, Defining "Tender Offer" Under the Williams Act, 53 Brook. L. Rev. 189, 203 (1987) (summarizing *Wellman* court's list).

47. Tender offers can take the form of an uncontested or "friendly" offer where the board approves the offer. They may involve the board itself attempting to buy its own shares in a "self-tender" offer. Or a third party may make an offer that the target's board rejects. See Prentice, supra note 1, at 393. Included in this last variety are the notorious "Saturday night specials" (tender offers with a ten-day time pressure), which have been prohibited; front-end loaded, two-tiered tender offers, which consist of "a cash offer that produces control, followed by acquisition of the remaining equity, generally at a lower price for debt or equity securities of the acquiring company," Loss, supra note 44, at 499; and "any and all" offers, where the bidder offers to purchase all shares tendered. See Prentice, supra note 1, at 393–94.

48. See Loss, supra note 44, at 499.

49. See Kahn v. Lynch Communications Sys., Inc., 669 A.2d 79, 85 (Del. 1995) (holding that where controlling shareholder offered lower price than independent

Those shareholders not initially tendering their shares pursuant to such an offer are forced to exchange their valued shares during the back end of the transaction for a lower cash payment or low-grade securities.[50]

The power of this technique—and considerable controversy—results from the lower amount paid for shares tendered during the second step of the offer. A front-end loaded offer presents shareholders with a "prisoner's dilemma":[51] "A shareholder who would prefer that the target remain independent will usually tender anyway out of fear that a majority of her fellow shareholders will tender, leaving her squeezed out of her investment at the lower second-tier price."[52] Although every shareholder might consider the bidder's offering price inadequate, the two-tiered offer will coerce all shareholders to tender in the face of this dilemma.[53]

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committee was willing to accept, but the threat of a hostile tender offer at an even lower price forced committee to approve controlling shareholder's initial offer, the controlling shareholder demonstrated entire fairness of transaction); Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1112–13 (Del. 1994) (holding under same circumstances that controlling shareholder dominated the merger negotiations despite the fact that target's board of directors appointed an independent negotiating committee); Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (holding that freezeout merger requires a showing of fair dealing and fair price); Singer v. Magnavox Co., 380 A.2d 969, 980 (Del. 1977) (holding use of corporate power solely to eliminate minority shareholders is violation of the fiduciary duty owed by the majority to minority shareholders and must comply with the entire fairness rule); see also Gilson & Black, supra note 30, at 1237–1313 (describing mechanics of, and case law regarding, freezeout mergers); Office of the Chief Economist, Securities & Exch. Comm'n, The Economics of Partial and Two-Tier Tender Offers, 49 Fed. Reg. 26,755 (1984) (discussing economic consequences of freeze-out mergers); Prentice, supra note 1, at 395 (explaining relation of freeze-out mergers to tender offers).

50. See, e.g., Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 40 (Del. 1993) (stating QVC's two-tiered tender offer comprised a cash payment in the first step followed by a payment of QVC equity securities in the second).

51. One scholar describes the prisoner's dilemma as a game in which "each player has a dominant strategy in the sense that the player is always better off choosing this strategy—to defect—no matter what the other player chooses. When both players choose a dominant strategy, given these assumptions, they produce an equilibrium that is the third-best result for both." Elinor Ostrom, Governing the Commons: The Evolution of Institutions for Collective Action 4–5 (1990).

52. Martin Lipton, Corporate Governance in the Age of the Finance Corporation, 136 U. Pa. L. Rev. 1, 19 (1987). See Seligman, supra note 44, at 1138 ("In the tender offer context, the shareholders of a target may feel they have to tender their shares when a bid is made below their estimation of a target's value out of fear that they will be stuck with post-tender offer stock selling at a lower price.").

53. Prentice describes this coercion as follows:

> The effect of front-end loaded, two-tiered tender offers is to "stampede" target shareholders into a decision to tender. The "whipsaw" effect is created by the "prisoner's dilemma." Although every shareholder may believe that the bid is too low and the wiser course would be to hold out for a higher bid, an inability to act cooperatively forces each shareholder to tender out of fear that if he does not tender, his fellow shareholders will, leaving him stuck with the lower back-end merger price.

Prentice, supra note 1, at 442 (footnotes omitted).

For this reason, virtually every court that has addressed this issue,[54] and most commentators writing on the subject,[55] have concluded that this type of offer constitutes a threat to shareholders' interests.[56] To combat this perceived coercion, poison pills were developed, a move which courts and commentators have supported despite the risk that the pill will entrench management.[57] Courts have sanctioned poison pills as a legiti-

54. See id. at 440; see, e.g., Desert Partners, L.P. v. USG Corp., 686 F. Supp. 1289, 1295 (N.D. Ill. 1988) (holding that the board's defensive strategy was reasonable in light of coercive two-tiered tender offer); CRTF Corp. v. Federated Dep't Stores, [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,680, at 98,121 (S.D.N.Y. Mar. 18, 1988) (holding that use of poison pill was reasonable response to threat of two-tiered offer); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985) (ruling that board of directors was reasonable in taking defensive measures against coercive acquisition techniques); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 (Del. 1985) ("It is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction."); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 113 (Del. Ch. 1986) (holding that two-tiered offer was coercive because no rational profit-maximizing shareholders could reject it).

55. See Prentice, supra note 1, at 440. See, e.g., F. Hodge O'Neal & Randolph B. Thompson, O'Neal's Oppression of Minority Shareholders § 5:26(A) (2d ed. 1986) (stating that the price differential of two-tiered offers may have coercive effect of pushing shareholders into "a hurried, unreasoned decision" to accept the higher, front-end price); Deborah A. DeMott, Current Issues in Tender Offer Regulation, 58 N.Y.U. L. Rev. 945, 946 (1983) (suggesting that present regulation of tender offers may not protect shareholders adequately); William D. Harrington, If It Ain't Broke, Don't Fix It: The Legal Propriety of Defenses Against Hostile Takeover Bids, 34 Syracuse L. Rev. 977, 1004 (1983) (stating two-tiered takeover bids provoke or coerce shareholders into tendering even though it is against their best interests); Jonathan R. Macey & Fred S. McChesney, A Theoretical Analysis of Corporate Greenmail, 95 Yale L.J. 13, 20 (1985) (discussing two-tiered offers in terms of a prisoner's dilemma for shareholders); Charles L. Marinaccio, Bidder, Target Balance Ought to Be Re-Evaluated, Legal Times, Mar. 25, 1985, at 16.

56. See Prentice, supra note 1, at 395, 439. Given the time value of money, any two-tiered tender offer, even if not front-end loaded, may arguably be coercive. See Lucian A. Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1695, 1710 (1985) (arguing that there is disparity in value of amount paid during front and back ends of tender offer even though amounts are nominally the same). Although the amount received at the back end of such a transaction may be nominally equivalent to the amount received at the front end, the back-end payment must be discounted to reflect the opportunity cost of capital. See Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 11–22 (4th ed. 1991); James van Horne, Financial Management and Policy 13–24 (7th ed. 1986), reprinted in Gilson & Black, supra note 30, at 64–73. Consequently, the back end amount will have a lower present value than the front end amount. This disparity will compel rational, wealth-maximizing shareholders to tender their shares. Thus, in this sense, all two-tiered tender offers are coercive.

57. See Prentice, supra note 1, at 412 ("One of the main purposes of poison pills . . . is to deter front-end loaded, two-tiered tender offers."); Coffee Affidavit, supra note 41, at ¶ 11 ("The actual intent [of a poison pill] was probably . . . to employ it to deter two-tier offers . . . ."). Poison pills were developed with the intention of assuring equality among shareholders. Rather than serving as a tool to block takeovers, the pill was intended to allow back-end shareholders the same deal presented to front-end shareholders. Another arguably plausible justification for the "flip-in" variety of poison pill is that it prevents "creeping" acquisitions, and thereby the possibility that the acquiror will steal the

mate defensive device to mitigate the coercive force of two-tiered tender offers;[58] and commentators have contended that the unfairness of two-tiered tender offers is the only justification for a target company's use of a poison pill.[59]

2. *Proxy and Consent Solicitations.* — The rise of unsolicited takeover contests utilizing a tender offer in combination with a proxy fight or consent solicitation has spurred target directors to find more effective impediments to such voting contests.[60] Traditional board strategies, such as restrictions on potential candidates for office or changes in the date of the annual shareholders' meeting,[61] have failed to ensure an incumbent victory.[62] As a result, boards have expanded the pill's defensive capacities to protect against proxy contests and consent solicitations in addition to protecting against hostile tender offers.[63] Pills have proven to be effective in "constraining dissident ownership" and thus in "discourag[ing] a potential dissident shareholder from commencing a contest."[64]

To appreciate how effectively poison pills interfere with voting contests, consider the two methods by which a dissident shareholder can win control of a corporation. The first is for the dissident alone to acquire enough shares in the market so that he or she can elect his or her own representatives to the board of directors by means of either a proxy contest or consent solicitation.[65] To accomplish this objective, the dissident would have to amass a control block, which usually requires over fifty percent of the target's outstanding shares. The amount may be less, how-

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shareholder's "control premium" by purchasing shares secretly and silently in the open market. See id. at ¶ 14. In such a situation, the pill forces the acquiror to negotiate with the target board of directors. See id.

58. See, e.g., Desert Partners v. USG Corp., 686 F. Supp. 1289, 1295–300 (N.D. Ill. 1988) (validating use of rights plan against unsolicited front-end loaded, two-tiered bid); CRTF Corp. v. Federated Dep't Stores, [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,680, at 98,118–21 (S.D.N.Y. Mar. 18, 1988) (same); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (identifying as threat posed for purposes of *Unocal* test, "the threat in the market place of coercive two-tier tender offers").

59. See Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred, 97 Harv. L. Rev. 1964, 1971–72 (1984); see also Prentice, supra note 1, at 412 ("Commentators have argued that [poison pills] can only be justified if they are used to defeat front-end loaded, two-tiered bids.").

60. See Thomas, supra note 21, at 505 (citing two examples).

61. See Gilson & Black, supra note 30, at 1402–70; Thomas, supra note 21, at 506 n.8; Judith R. Thoyer & Carl L. Reisner, IBM's Recent Threat to Replace Lotus' Board Demonstrates the Vulnerability of Clients to Voting Contests When They Are Defending Against Pending Takeovers, Nat'l L.J., July 10, 1995, at B6.

62. See Thomas, supra note 21, at 506.

63. See id. at 510; see also Gilson & Black, supra note 30, at 1434 ("Anecdotal evidence confirms that companies sometimes adopt poison pills, or reduce pill thresholds, to prevent an already known dissident from buying more shares.").

64. Randall S. Thomas & Kenneth J. Martin, The Impact of Rights Plans on Proxy Contests: Reevaluating *Moran v. Household International*, 14 Int'l Rev. L. & Econ. 327, 336 (1994).

65. See Thomas, supra note 21, at 512.

ever, if the company is widely held and few shareholders hold a large stake. An incumbent board could defend against this method of gaining control with a poison pill, since the pill's discriminatory dilutive effects would reduce the dissident's stake in the company on a percentage basis.[66] Dissidents would be reluctant to accumulate enough shares to trigger a pill because the voting power of any holdings would be diluted by the pill's flip-in or flip-over features.[67]

The second method of winning control is for the dissident to induce other shareholders to vote their shares in support of the dissident's slate of candidates and agenda during a proxy or consent solicitation.[68] A pill may introduce substantial impediments to a dissident following this route as well. For example, most pills count shares held by all "beneficial owners" when determining whether the trigger point has been crossed.[69] As in the Rule 13d-3 definition,[70] "[a] shareholder group is considered to be the beneficial owner of any stock that it has the right to vote, either directly or indirectly, except pursuant to revocable proxies given in response to public solicitations that the SEC has reviewed."[71]

As a result of the beneficial owner definition, dissidents will be unable to take certain actions necessary to accomplish a successful proxy battle or consent solicitation.[72] One such action is communication among shareholder groups. Some boards use poison pills to halt discussions among potential dissident groups "by threatening to trigger the

66. See supra text accompanying note 23.

67. See Thomas, supra note 21, at 512. The effect of the poison pill on this method of gaining control is that "[t]he trigger level . . . sets a ceiling on the amount of stock that any shareholder can accumulate before launching a proxy contest" or consent solicitation. Id. The trigger level consequently negatively affects the chances of shareholders to gain effective control of the company. Most triggering thresholds are commonly set at 20%. See Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 551 n.100 (1990). At least one court has invalidated a pill with a threshold of less than 20%. See Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 259–60 (7th Cir. 1986) (invalidating CTS's poison pill with a trigger level set at 15%), rev'd, 481 U.S. 69 (1987). Nevertheless, the general trend is toward corporate implementation of lower thresholds. See Thomas, supra note 21, at 512. For example, America Online Inc. lowered its threshold from 25% to 15%, see America Online Toughens Provisions of Poison Pill, Wall St. J., Feb. 2, 1995, *available in* 1995 WL-WSJ 2108578; Amgen Inc. reduced its threshold from 15% to 10%, see Frederick Rose, Amgen's Board Tightens Provisions of "Poison Pill," Wall St. J., Feb. 22, 1995, *available in* 1995 WL-WSJ 2113700; and Chrysler has set its trigger level at 15%, see Angelo B. Henderson & Gabriella Stern, Chrysler Board Seat is Nonnegotiable to Avert a Fight, Wall St. J., Jan. 3, 1996, at B3.

68. See Thomas, supra note 21, at 512. See generally Seligman, supra note 44, at 718–25 (describing proxy rules and consent solicitations).

69. See Gilson & Black, supra note 30, at 1435; Thomas, supra note 21, at 513.

70. See Securities Exchange Act of 1934 § 13[d][3], 15 U.S.C. § 78m(d)(3) (1994).

71. Thomas, supra note 21, at 513; see Warren & Abrams, supra note 40, at 663.

72. See In re Chrysler Corp. Shareholders Litig., [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,996, at 94,348–49 (Del. Ch. July 27, 1992) (acknowledging that in proxy fights, poison pills deter cooperation among, and effective action by, dissident shareholders); Gilson & Black, supra note 30, at 1435; Warren & Abrams, supra note 40, at 663.

[pill] if any such discussions take place."[73] Preventing communication among parties large enough to run a successful voting contest will deter those parties from commencing the solicitation.[74] Another action often necessary for the commencement of a voting contest is an agreement among dissident shareholder groups regarding the sharing of costs and other responsibilities associated with the solicitation. Voting contests often can be too costly for one group to undertake without sharing expenses. Because entering such agreements would establish the dissident groups as beneficial owners, such action likely would trigger the pill. As a result, these dissidents would never formulate such contracts.[75]

3. *Summary of the Effects of Poison Pills.* — In light of the above, one must distinguish the two effects of a poison pill. When a pill is used to defend against a hostile tender offer, the pill's defensive capacities support shareholders in their struggle against coercive raiders. In contrast, when a pill is used as a defense against a proxy or consent solicitation, there is no threat to shareholders. Unlike tender offers, voting contests present no collective action problems which coerce shareholders into acting contrary to their true preferences. Thus, poison pills provide no protection to shareholders in voting contests because none is warranted. Rather, pills support incumbent directors and management in their struggle to insulate themselves from the vote of the majority of the company's owners.[76]

The implementation of pills to defend against voting contests thus infringes shareholder voting rights and violates the board's fiduciary duties to shareholders.[77] While courts have upheld poison pills as a defense against coercive raiders, "[no] court has ever accepted the idea that poison pills should protect shareholders from themselves: that is, from their own right and ability to elect a different board of directors."[78]

73. Thomas & Martin, supra note 64, at 336; see Thomas, supra note 21, at 514. He points out one case where "two large shareholders could not even discuss the possibility of launching a proxy contest under the terms of the target company's Rights Plan." Id. at 514 (citing Henley Group, Inc. v. Santa Fe S. Pac. Corp., No. 9569, 1988 Del. Ch. LEXIS 32, at *16–17 (Del. Ch. Mar. 11, 1988)). In a second matter, "the target company's poison pill retirement plan prevented shareholders from accepting more than 35% of the revocable proxies cast in an election." Id. (citing Sutton Holding Corp. v. Desoto, Inc., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,012, at 90,064 (Del. Ch. May 14, 1991)). In both cases, the courts were understandably critical of the use of the rights plans.

74. See Thomas & Martin, supra note 64, at 336.

75. See id.; Warren & Abrams, supra note 40, at 663.

76. See Thomas & Martin, supra note 64, at 327.

77. See infra notes 159–163 and accompanying text. The risk of such infringement is a source of concern, for as one commentator explains: "[T]he market for corporate control in the post-poison pill era must ultimately rely on the shareholders' right to elect their agents." Robert J. Klein, Note, The Case for Heightened Scrutiny in Defense of the Shareholders' Franchise Right, 44 Stan. L. Rev. 129, 138 (1991).

78. Coffee Affidavit, supra note 41, ¶ 23.

C. *Adverse Impact of Continuing Directors Provisions on Voting Rights*

In addition to the above adverse effects of a poison pill on an insurgent shareholder's attempt to win control of the company, the insurgent's prospects for success may be precluded altogether if the target's rights plan contains a continuing directors provision.[79] This provision permits only those directors in office prior to the triggering of a pill to approve its redemption.[80] The continuing directors provision enacted by Irving Bank Corporation on March 15, 1988 illustrates the discriminatory restriction placed on future boards.[81]

The Irving provision created several classes of directors, each with different rights. The first group included the "directors who were in office prior to March 15, 1988, and who [had] all rights of directors."[82] Second were the "directors who [were] elected after March 15, 1988 and

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79. An example of a typical continuing directors provision is the one enacted by Irving Bank Corporation on March 15, 1988. One month before Irving enacted the provision, the Bank of New York Company commenced a proxy fight with the intent of electing a new board of directors. Irving Bank Corporation responded by amending its shareholder rights plan to include a continuing directors provision. It states:

> [T]he Board of Directors of the company shall be entitled so to redeem the Rights only if it consists of a majority of Continuing Directors (as hereinafter defined) or, if the Board of Directors of the Company is not so constituted, only if the members of the Board of Directors of the Company who are not Continuing Directors were elected to immediately succeed Continuing Directors and either (i) were elected by the affirmative vote of the holders of at least two-thirds of the issued and outstanding Shares of the Company or (ii) in connection with the election of the members of the Board of Directors of the Company who are not Continuing Directors, no merger, consolidation, liquidation, business combination or similar transaction or series of transactions with respect to the Company is or was proposed. The term "Continuing Director" shall mean a director who either was a member of the Board of Directors of the Company prior to March 15, 1988 or who subsequently became a director of the Company and whose election, or nomination for election by the Company's shareholders, was approved by a vote of a majority of the Continuing Directors then on the Board of Directors of the Company.

Bank of N.Y. Co. v. Irving Bank Corp., 528 N.Y.S.2d 482, 483 (Sup. Ct. 1988) (quoting, in relevant part, section 23 of amended Irving Bank shareholder rights plan).

The following is a section of Computervision, Inc.'s continuing directors provision defining "continuing director" as:

> (i) any member of the Board, while such Person is a member of the Board, who is not an Acquiring Person, or an affiliate or Associate of an Acquiring Person or of any such Affiliate or Associate, and was a member of the Board prior to the date of this Agreement, or (ii) any Person who subsequently becomes a member of the Board, who is not an Acquiring Person, or an Affiliate or Associate of an Acquiring Person, or a representative of an Acquiring Person or of any such Affiliate or Associate, if such Person's nomination for election or election to the Board is recommended or approved by a majority of the Continuing Directors.

Prime Computer, Inc. v. Allen, No. CIV.A. 9557, 1988 WL 5277, at *8 n.1 (Del. Ch. Jan. 25, 1988) (quoting Rights Agreement, § 1(i), Strum Aff. Ex. A, at 4).

80. See infra note 148 and accompanying text.

81. *Bank of N.Y.*, 528 N.Y.S.2d at 483.

82. Id.

whose election was approved by a vote of the majority of the first group. This group also [had] all the rights of directors."[83] Third were "directors elected after March 15, 1988 and who [had] not postponed or agreed to certain actions relating to mergers. These [were] the actions which the first group [had] decided to block."[84] The continuing directors provision's terms stripped the third group of the power to redeem the poison pill, although the group retained all other directorial powers.[85]

If included in the rights plan, this provision enables a board using a "just say no" defense to resist an insurgent's combined tender offer and voting contest.[86] Even if the insurgent were to be successful in a voting contest, an immediate takeover would be impossible because the poison pill would be permanently locked in place until its expiration.[87] The continuing directors provision would foreclose the insurgent's ability to gain control of the target corporation under these conditions, regardless of other shareholders' sentiments regarding the transaction's desirability.[88] In effect, by restricting the right of future boards to redeem the pill, the entrenched board would have entirely stripped the shareholders of their sovereignty as owners of the company.

Poison pills containing continuing directors provisions thus have vast potential to hinder voting contests, as well as to block hostile tender offers. The interests of the board may, as a result, conflict with those of shareholders when the former, responding to a control threat, adopts such a pill. Nevertheless, the corporate law of Delaware, as well as of most other states, permits the board to implement poison pills at its discretion and without shareholder approval.[89] Courts, however, do place

83. Id.

84. Id. at 483–84.

85. See id. at 484.

86. See supra note 44.

87. See Coffee Affidavit, supra note 41, at ¶ 21. Poison pills are typically enacted with a life span of ten years. See 1 Fleischer & Sussman, supra note 2, § 5.05[D], at 5-77. However, they may also expire after shorter durations, such as five years. See 1 id.

88. In fact, the continuing directors provision is structured so that, ironically, "the more a shareholder wants [a dissident's] transaction to succeed, the more he will be reluctant to vote for the [dissident's] slate of directors, because their election forecloses any such transaction." Coffee Affidavit, supra note 41, at ¶ 26. A proxy contest run successfully against a target company with a poison pill containing a continuing directors provision will preclude the redemption of the poison pill and therefore the completion of the transaction until the expiration of the poison pill. Those shareholders most desiring a sale of the company will favor voting for the incumbent board—which *does not* support the sale—over voting for the insurgent slate—which *does* support the sale—because otherwise no sale will be effected for the duration of the company's poison pill. "[A] shareholder who wished on the merits to vote for [a dissident's] slate of directors must balance against that preference the impact that foreclosing redemption of the Poison Pill will have on his desire to have the [dissident's] proposal consummated." Id. Thus, the continuing directors provision coerces shareholders into supporting a slate which they would otherwise prefer to remove from office. See Lipin, Revco, supra note 5, at B4.

89. See 1 Fleischer & Sussman, supra note 2, § 5.01[B], at 5-9; 1 Folk et al., supra note 4, § 157.10, at 157:23–24; supra note 28 and accompanying text.

restrictions on the board's actions in adopting and implementing a pill. Any pill will be subject to the business judgment rule[90] as modified in *Moran v. Household International, Inc.*[91] and *Unocal Corp. v. Mesa Petroleum Co.*[92]

Despite its discriminatory impact, the continuing directors feature of poison pills has largely evaded judicial review. One explanation for this phenomenon may be that, as in the case of J&J's bid for Cordis,[93] pill redemption is negotiated as part of the contest's resolution, so the issue never reaches the courthouse.[94] Another may be that raiders abandon their efforts to take control of target companies after the targets take some action, such as the sale of a valuable subsidiary or division, which dissuades the raiders from proceeding with the acquisition.[95] Nevertheless, those courts that have faced this issue have tended not to address it, instead resolving the matter on some other ground.[96]

Predictably, scholars dare to go where judges fear to tread. Numerous commentators have sought the invalidation of pills that encroach on shareholder voting rights. Some have advocated that "[j]udges should look carefully at the particular features of a Rights Plan before drawing any conclusion about how it affects a corporate election."[97] Others have called for judges to "assess the reasonableness of incumbents' responses to . . . threats based on the defensive tactics' impact on a dissident's chances of winning a proxy contest."[98] Such assessments are especially needed in the case of continuing directors provisions which can entirely preclude successful proxy contests or consent solicitations. According to these scholars, devices that eliminate shareholders' ability to express dissatisfaction with the incumbent board must be invalidated.[99] Pills containing continuing directors provisions fall within this category.

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90. "The business judgment rule is a 'presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.' " Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

91. 500 A.2d 1346, 1350 (Del. 1985).

92. *Unocal* modified this rule by requiring the application of a proportionality test to the board's defensive actions "at the threshold before the protections of the business judgment rule may be conferred." *Unocal*, 493 A.2d at 954–55.

93. See supra text accompanying notes 7–13.

94. See supra text accompanying note 36.

95. For example, the litigation involving Commercial Intertech Corp.'s (CIC) continuing directors provision was dropped when United Dominion Industries withdrew its tender offer after CIC received court approval to spin off its largest subsidiary. See Steven Lipin, Investing in Mergers Turns Perilous As Deals Collapse, Wall St. J., Aug. 6, 1996, at C1.

96. See infra Part II.C.

97. Thomas & Martin, supra note 64, at 336.

98. Thomas, supra note 21, at 507.

99. See id. at 507, 560; Thomas & Martin, supra note 64, at 336–37; see also Warren & Abrams, supra note 40, at 654 (calling for judicial invalidation of infringing actions).

II. The Limits of Jurisprudence Relating to Continuing Directors Provisions

Corporate jurisprudence recognizes the shareholder vote as the underpinning of directorial legitimacy.[100] This recognition is reflected in the judicial standards of review of board action that may potentially infringe the shareholder electoral franchise. However, current judicial review of continuing directors provisions is inconsistent with the Delaware Supreme Court's own standards relating to shareholder sovereignty and directorial defensive actions. An examination of the standards used to judge the validity of a board's implementation of a shareholder rights plan and directorial actions that affect shareholder voting rights, as well as the application of these standards to continuing directors provisions, demonstrates this inconsistency.

A. *Judicial Review of Shareholder Rights Plans*

Two issues arise in connection with the utilization of rights plans. First is the issue of the pill's basic validity. The court in *Moran v. Household International, Inc.*[101] held that the target's board was authorized pursuant to Delaware General Corporate Law (DGCL) section 157 to issue rights[102] and DGCL section 151 to issue the underlying preferred stock.[103] Although this case involved flip-over rights, it is generally accepted that the holding applies to flip-in rights as well.[104] The pill's validity was called into question in another case on the ground that discriminating among similar classes of stock is illegal, and the pill's rights are discriminatory in nature. On the authority first articulated by the Delaware Supreme Court in *Providence & Worcester Co. v. Baker*,[105] the Seventh Circuit held that pills only discriminate against a particular category of shareholders and not against shares.[106] The court reasoned that all

100. See text accompanying note 140.

101. 500 A.2d 1346 (Del. 1985).

102. See Del. Code Ann. tit. 8, § 157 (1991); *Moran*, 500 A.2d at 1351.

103. See Del. Code Ann. tit. 8, § 151 (1991); *Moran*, 500 A.2d at 1351.

104. See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). The first case to uphold flip-in rights was Stahl v. Apple Bancorp, Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,412 (Del. Ch. Aug. 9, 1990).

105. 378 A.2d 121, 123 (Del. 1977) (distinguishing "limitations upon the voting rights of the stockholder" from "variations in the voting power of stock *per se*" and indicating that the former is consistent with statutory language).

106. See Dynamics Corp. of Am. v. CTS Corp., 805 F.2d 705, 718 (7th Cir. 1986). In *CTS Corp.*, a tender offeror sought to enjoin attempts by the target corporation to use a poison pill to prevent a takeover. One issue was whether a poison pill's method of preventing takeovers was prohibited by an Indiana statute, Ind. Code § 23-1-25-1(a) (1986), providing that all shares of a particular class of stock must have preferences, limitations and relative rights identical with those of other shares. See *CTS Corp.*, 805 F.2d at 717. The court looked to DGCL § 151(a) (1986) for guidance in resolving this issue and held that the poison pill did not discriminate against shares; it only discriminated against shareholders, an act that was permissible under Indiana and Delaware law. See *CTS Corp.*, 805 F.2d at 718.

shares are treated equally in that each carries the same rights as all other shares. These rights include the stipulation that the entitlements of the rights plan's dividend will not be conferred to a raider.[107] Thus, courts have approved the underlying structural validity of pills.

The second principal issue is that of the board's fiduciary duties in adopting the pill and using and redeeming the pill in the face of a hostile bid. A portion of the *Moran* court's analysis involved an assessment of the pill's impact on proxy fights. The court's decision to uphold the pill was predicated partially on its finding that "the effect [of pills] upon proxy contests will be minimal."[108] Regardless of the accuracy of the court's conclusion that pills do not affect proxy fights,[109] the implication of this holding is that if a pill were actually to hinder a proxy contest, the pill would be held invalid. Later cases echo this interpretation of the *Moran* decision.[110] Consequently, as one scholar summarized, "when Delaware courts uphold a poison pill rights plan, they often find as a precondition . . . that the insurgent shareholder or group could still 'safely wage its proxy contest free from the dramatic effect of the poison pill.' "[111]

As a framework for addressing the propriety of defensive actions taken by a board, courts have applied the two-pronged proportionality test outlined in *Unocal Corp. v. Mesa Petroleum Co.*[112] Although a poison pill was not at issue in *Unocal*, its standard applies to all defensive devices, including poison pills, implemented by Delaware corporations.[113] The first prong of the *Unocal* test requires the target company's board to demonstrate that after a reasonable investigation it determined in good faith that the insurgent's offer posed a threat that justified defensive ma-

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107. See 1 Fleischer & Sussman, supra note 2, § 5.02[A], at 5-15 n.39.

108. *Moran*, 500 A.2d at 1355.

109. Commentators, criticizing the *Moran* court's finding, contend that it was based "on weak statistical evidence." Thomas & Martin, supra note 64, at 327. These scholars analyze more recent and comprehensive data and conclude that rights plans do in fact negatively impact the ability of shareholders to win a proxy contest: "[I]n the absence of Rights Plans, dissidents could have acquired larger blocks of stock (or formed stronger coalitions), which in turn would have led to a higher proportion of dissident victories." Id. at 328.

110. See, e.g., Moore Corp. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545, 1463–64 (D. Del. 1995) (holding that poison pill did not hinder proxy contest and was consequently not invalid); Sutton Holding Corp. v. DeSoto, Inc., 1991 Fed. Sec. L. Rep. (CCH) ¶ 96,012 (Del. Ch. May 14, 1991) (invalidating rights plan that hindered proxy contest).

111. Coffee Affidavit, supra note 41, ¶ 13 (quoting *Moore Corp.*, 907 F. Supp. at 1563).

112. 493 A.2d 946 (Del. 1985). The *Unocal* court asserted that, in light of "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty . . . before the protections of the business judgment rule may be conferred." Id. at 954. For cases addressing the validity of poison pills under the *Unocal* standard, see CRTF Corp. v. Federated Dep't Stores Inc., 683 F. Supp. 422, 439–41 (S.D.N.Y. 1988); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180–81 (Del. 1986); Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049, 1057–58 (Del. Ch. 1988).

113. See *Moran*, 500 A.2d at 1350.

neuvers.[114] The test's second prong mandates a showing that the board's response was proportional to the threat presented by the change in control.[115] If the board's action satisfies the requirements of the *Unocal* test, the court will review the board's action under the business judgment rule. If not, the court will invalidate the pill.[116]

Judicial standards for implementing the *Unocal* test in the directorial defensive action context have oscillated dramatically in recent years. In 1989, the Delaware Supreme Court in *Paramount Communications, Inc. v. Time Inc.* expanded the target board's ability to resist a tender offer.[117] The court rejected limitations on the types of threats that satisfy the first prong of the *Unocal* test and extended the range of qualifying threats beyond those that prior chancery court decisions had established.[118] In addition, the court overturned lower court decisions emphasizing an independent judicial review of a board's determination that a threat exists, replacing it with a looser business judgment-style review.[119] The *Time* court's deferral to the board's decisions prompted one commentator to speculate that this decision "may mark the collapse of heightened judicial scrutiny for takeover defensive tactics against hostile tender offers and a retreat to their deferential review under the business judgment rule."[120]

However, the court's decision in *Paramount Communications Inc. v. QVC Network Inc.*[121] temporarily disproved this speculation. The *QVC* court reversed the pro-management momentum and reverted back to

114. See *Unocal*, 493 A.2d at 955.

115. See id.

116. See id. at 958.

117. See 571 A.2d 1140, 1152–53 (Del. 1989).

118. See *Time*, 571 A.2d at 1152–53, which overruled City Capital Assocs. v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988), and its progeny, and rejected plaintiffs' claim that an unsolicited tender offer presents only two types of threats: "the threat of coercion that results from a two-tier offer promising unequal treatment for nontendering shareholders; and the threat of inadequate value from an all-shares, all-cash offer at a price below what a target board in good faith deems to be the present value of its shares." Id.

119. See *Time*, 571 A.2d at 1153 (stating that "precepts underlying the business judgment rule militate against a court's engaging in the process of attempting to appraise and evaluate the relative merits of a long-term versus a short-term investment goal for shareholders").

120. Thomas, supra note 21, at 517; see also Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 Stan. L. Rev. 857, 859 n.4 (1993) (claiming that the *Time* "decision will likely deter hostile [takeover] activity because as long as a potential bidder perceives a sufficiently high probability that *Time*'s logic will allow an incumbent board to defeat her highest rational offer, *Time* can deter a bidder from ever making any offer"). See generally Trevor S. Norwitz, "The Metaphysics of Time": A Radical Corporate Vision, 46 Bus. Law. 377, 378 (1991) (describing *Time* court's "shift in emphasis . . . away from the shareholders' interests in maximum profitability towards the recognition of other corporate interests"); Marc I. Steinberg, Nightmare on Main Street: The *Paramount* Picture Horror Show, 16 Del. J. Corp. L. 1, 2 (1991) ("In Delaware today, shareholder protection is all too often largely rhetorical, lacking in substantive content.").

121. 637 A.2d 34 (Del. 1993).

what could be viewed as a "more shareholder-friendly standard."[122] The court enjoined certain defensive measures[123] which Paramount's board implemented to facilitate a synergistic alliance with Viacom, Inc. and to impede QVC's more valuable hostile tender offer.[124] The court reasoned that the Paramount board's primary obligation was to use its informed judgment for the "realization of the best value reasonably available to the stockholders."[125] To ensure that boards satisfy this requirement, courts must subject the boards' actions to "enhanced judicial scrutiny"[126] whenever an extraordinary corporate transaction occurs.[127]

In *Unitrin, Inc. v. American General Corp.*,[128] however, the court restrained the reach of *QVC*'s enhanced judicial scrutiny standard. The *Unitrin* court overruled a lower court's determination that the target board's actions in defending against a hostile tender offer[129] were "unnecessary" and therefore "disproportionate" under the second prong of the *Unocal* test.[130] The *Unitrin* Court stated that "a court applying enhanced judicial scrutiny should be deciding whether the directors made *a reasonable* decision, not *a perfect* decision."[131] According to the court, the pertinent question is whether the target board's defensive maneuvers fall within a "range of reasonableness."[132] The court indicated that any defensive action falls outside the range of reasonableness if it can be characterized as "draconian," by which the court meant to signify "preclusive or

122. Lawrence A. Cunningham & Charles M. Yablon, Delaware Fiduciary Duty Law After *QVC* and *Technicolor*: A Unified Standard (and the End of *Revlon* Duties?), 49 Bus. Law. 1593, 1595 (1994); see also Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (subjecting board action in takeover scenario to judicial scrutiny under "entire fairness" standard of review); Seligman, supra note 44, at 1240 (predicting "the *QVC* decision . . . may well portend the rebirth of the hostile tender offer").

123. These defensive measures included a revised poison pill that exempted the merger with Viacom, a no-shop provision, a termination fee provision favorable to Viacom, and a stock option agreement also with terms very favorable to Viacom. See *QVC*, 637 A.2d at 39.

124. See id. at 36.

125. Id. at 51.

126. Id. at 45.

127. See Gilson & Black, supra note 30, at 1152–53; Cunningham & Yablon, supra note 122, at 1594 (maintaining that this standard is "potentially applicable to a broad range of managerial decisions regarding control and other extraordinary corporate events").

128. 651 A.2d 1361 (Del. 1995).

129. In response to American General's (the bidder) tender offer for the stock of Unitrin (the target), the Unitrin board adopted a poison pill and commenced a stock repurchase program. See id. at 1370–71.

130. Id. at 1385 ("The Court of Chancery applied an incorrect legal standard when it ruled that the Unitrin decision to authorize the Repurchase Program was disproportionate because it was 'unnecessary.' ").

131. Id. (quoting Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994)).

132. Id. at 1386.

coercive."[133] Thus, after *Unitrin*, a defensive action that can be characterized as preclusive or coercive will fail the second prong of the *Unocal* test. However, there remains a large gap between what would be unacceptable under the *QVC* heightened scrutiny standard and yet not "preclusive or coercive" as described by *Unitrin*.

Although the decisions demonstrate the unsettled state of the law governing boards' defensive actions, one thing is clear: the trend is toward relaxing the applicable level of scrutiny used to ensure that target company boards properly exercise their fiduciary duties with respect to tender offers. But while this relaxed standard of scrutiny may be adequate to review defensive actions protecting against hostile tender offers, the standard should be raised when used to analyze defenses against a proxy or consent solicitation.[134] Voting contests, as opposed to tender offers, merit additional judicial attention because "[d]irector action designed to interfere with the [voting] franchise alters the allocation of authority between the shareholders and the board that governs the corporation."[135] That directors may employ rights plans to deprive shareholders of the ability to choose the company's directors contradicts widely shared notions of appropriate corporate governance and, as such, diminishes the legitimacy and authority of corporate law.

B. *Judicial Review of Actions that Infringe the Shareholder Electoral Franchise*

The Delaware Chancery Court in *Blasius Industries v. Atlas Corp.*[136] stated what some scholars consider to be the "most important contemporary articulation of the judicial framework for reviewing a board of direc-

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133. Id. at 1387. The court stated that "defensive measures which are either preclusive or coercive are included within the common law definition of draconian." According to the court, a defensive action is "preclusive" if it deprives "the stockholders of their rights to receive tender offers [or] fundamentally restrict[s] proxy contests." Id. A defensive act is "coercive" if it is "aimed at 'cramming down' on . . . shareholders a management-sponsored alternative." Id. The court's rationale for this standard is as follows:

> The *ratio decidendi* for the "range of reasonableness" standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint. Consequently, if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a "range of reasonableness," a court must not substitute its judgment for the board's.

Id. at 1388.

134. See Thomas, supra note 21, at 507. See generally Warren & Abrams, supra note 40, at 663–65 (discussing applicable standards of review of poison pills in proxy contests).

135. Thomas, supra note 21, at 526; see Stahl v. Apple Bancorp, Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,412, at 97,035 (Del. Ch. Aug. 9, 1990) (stating that whenever voting franchise is at stake, "a special obligation falls upon courts to review with care action that impinges upon legitimate election activities"); Blasius Indus. v. Atlas Corp., 564 A.2d 651, 660 (Del. Ch. 1988) (requiring judicial review of acts that reallocate authority).

136. 564 A.2d 651 (Del. Ch. 1988).

tors' actions that affect the stockholder franchise."[137] In *Blasius*, the board of Atlas (the target company) attempted to prevent a loss of control resulting from a consent solicitation that would place a majority of new directors on its board. Despite acknowledging that the board had acted in good faith in responding to the threat posed by Blasius, the court determined that it must provide "closer scrutiny" of the board's action than would be provided under the *Unocal* test because the board's action was designed primarily to interfere with the electoral franchise of stockholders.[138] Although the *Blasius* court distinguished its own test from that of *Unocal*, later cases treated the *Blasius* standard as a "specific expression" of the *Unocal* test.[139]

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137. Warren & Abrams, supra note 40, at 654.

138. See *Blasius*, 564 A.2d at 659.

139. Shamrock Holdings v. Polaroid Corp., 559 A.2d 278, 285–86 (Del. Ch. 1989); see, e.g., Stroud v. Grace, 606 A.2d 75, 92 n.3 (Del. 1992) ("We note that the two 'tests' are not mutually exclusive because both recognize the inherent conflicts of interest that arise when shareholders are not permitted free exercise of their franchise."); *Apple Bancorp, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,036 (concluding that *Blasius* and *Unocal* standards are "structurally similar and may . . . be functionally similar as well"). Although "[m]any of the litigants and the courts . . . have treated the *Blasius* standard as requiring a more searching and critical judicial inquiry than the *Unocal* framework," commentators, as well as Delaware courts, have recognized that "*Blasius* may be viewed as a reformulation and not necessarily an extension of *Unocal* in the context of stockholder voting rights." Warren & Abrams, supra note 40, at 669. Such commentators reason that "[b]y inquiring into both the incumbent directors' motives and the practical effect of their tactics on the insurgents' proxy or consent solicitation, *Blasius* parallels the two-prong *Unocal* inquiry into the target directors' reasonable perception of a threat to a valid corporate interest, and the proportionality of their response to the threat." Id.

"Board action interfering with the exercise of the franchise often [arises] during a hostile contest for control where an acquiror [launches] both a proxy fight and a tender offer." *Stroud*, 606 A.2d at 92 n.3. In such a scenario, the incumbent board likely will contend that any defensive action it takes is intended primarily to defend against the tender offer rather than the voting contest and thus should be scrutinized under only the *Unocal* proportionality standard. The Delaware Supreme Court, stating that both *Unocal* and *Blasius* apply to such a case, reconciled the two standards:

> In certain circumstances, a court must recognize the special import of protecting the shareholders' franchise within *Unocal*'s requirement that any defensive measure be proportionate and "reasonable in relation to the threat posed." A board's unilateral decision to adopt a defensive measure touching "upon issues of control" that purposefully disenfranchises its shareholders is strongly suspect under *Unocal*, and cannot be sustained without a "compelling justification."

Id. (citations omitted).

For purposes of this Note, therefore, reference will be made only to the *Unocal* standard in determining the legality of continuing directors provisions under Delaware law. This Note applies *Unocal* for three reasons. First, the application of one test or the other will not affect the outcome of a court's determination with respect to the validity of a continuing directors provision. As Delaware courts and commentators have observed, "the choice of a particular form of judicial review between the *Unocal* and *Blasius* formulation probably is not determinative." Warren & Abrams, supra note 40, at 669–70; see *Stroud*, 606 A.2d at 92 n.3; *Apple Bancorp, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,036; *Shamrock Holdings*, 559 A.2d at 286. Second, analysis under *Unocal* responds to the strongest argument incumbent boards can offer in support of continuing directors

The *Blasius* court, addressing the central importance of the shareholder electoral franchise, reasoned:

> The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.
>
> . . . Thus, when viewed from a broad, institutional perspective, it can be seen that matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.[140]

As a result, courts will refuse to apply the deferential business judgment rule in their review of board actions designed to infringe shareholder voting rights, regardless of the board's motivations.[141]

Blasius also discussed the allocation of authority between directors and shareholders. This issue requires an examination of the nature of the shareholder vote as it relates to the powers delegated to a board:

> [I]t appears that the ordinary considerations to which the business judgment rule originally responded are simply not present in the shareholder voting context. That is, a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance. That . . . will be true in every instance in which an incumbent board seeks to thwart a shareholder majority. A board's decision to act to prevent the shareholders from creating a majority of new board positions and filling them does not involve the exercise of *the corporation's power* over its property, or with respect to *its* rights or obligations; rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation. . . . Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal. This is not, in my opinion, a question that a court may leave to the agent finally to decide so long as he does so honestly and com-

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provisions. Third, if a board's implementation of a continuing directors provision fails to satisfy the *Unocal* standard, the board can offer no "compelling justification" to sustain its decision to enact the device.

140. *Blasius*, 564 A.2d at 659; see also Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1378 (Del. 1995) ("This Court has been and remains assiduous in its concern about defensive actions designed to thwart the essence of corporate democracy by disenfranchising shareholders."); Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1994) ("Because of the overriding importance of voting rights, this Court and the Court of Chancery have consistently acted to protect stockholders from unwarranted interference with such rights.").

141. See *Blasius*, 564 A.2d at 659 ("The deferential business judgment rule does not apply to board acts taken for the primary purpose of interfering with a stockholder's vote, even if taken advisedly and in good faith.").

> petently; that is, it may not be left to the agent's business judgment.[142]

Thus, on the basis of directorial legitimacy and allocation of power, the *Blasius* court mandated close judicial scrutiny of board actions that interfere with the shareholder vote.

C. *Judicial Review of Continuing Directors Provisions*

As noted above, continuing directors provisions interfere with the shareholder voting franchise.[143] Such provisions empower incumbents to defeat insurgents in voting contests. For this reason, the court's decision in *Bank of New York Co. v. Irving Bank Corp.*[144] that enjoined a rights plan containing a continuing directors provision is not surprising. The court held that the provision violated New York corporate law, under which any restrictions placed on the power of the board of directors must be included in the certificate of incorporation.[145] The court's holding disposed of the issue on this statutory ground and included no finding of invalidity on any other independent basis.

According to the *Bank of New York* court, the power of Irving Bank's board of directors was restricted by the discriminatory features of the continuing directors provision. In particular, the court criticized the provision's selectivity in depriving certain boards of their directorial powers[146] and found that the provision discriminated among different directors depending on the circumstances of their election.[147] The court concluded that the provision "effectively limit[ed] the powers of a future board which is not a continuation of the present board or which is not approved by it, while still leaving those powers to a board which is approved."[148]

142. Id. at 659–60 (footnote omitted).

143. See supra note 88 and accompanying text.

144. 528 N.Y.S.2d 482 (Sup. Ct. 1988).

145. See id. at 485 (applying N.Y. Bus. Corp. Law § 620 (McKinney 1986 & Supp. 1996)). Although it has not been adjudicated in a Delaware court, this statutory issue would most likely be resolved in the same manner under Delaware law. The corresponding Delaware statute contains equivalent requirements. See Del. Code Ann. tit. 8, § 141(a) (1995).

146. See *Bank of N.Y.*, 528 N.Y.S.2d at 485.

147. See id. at 483–84. For a discussion of these distinctions, see supra text accompanying notes 82–84.

148. *Bank of N.Y.*, 528 N.Y.S.2d at 484. This effect has serious implications for the shareholder voting franchise. Even though a future board may have been properly voted into office by a majority of the shareholders, the board will fail to possess full power to redeem the rights plan if the current board does not approve the future board. At the same time, the provision empowers the current board, or one it approves, to redeem the plan. This situation was analogized in *Bank of New York* to the power of a board to enter into a long-term contract:

> [T]he present board has the power to restrict corporate action and bind the corporation for long periods of time. However, when a board enters into a contract for the benefit of a corporation, not only is it carrying on the business of the corporation, but, if it did not have the power to do so, the business could not be carried on. In emphasis, the board may not enter into a contract which may

Because this restriction was not enumerated in the certificate of incorporation, the provision was held to violate New York law.[149]

Delaware courts are generally considered the leaders in corporate jurisprudence.[150] However, unlike their New York counterparts, Delaware courts have never invalidated a continuing directors provision, despite having had the opportunity to do so.[151] This result conflicts with Delaware jurisprudence maintaining that the shareholder vote serves as the ideological basis of the claim to directorial legitimacy.[152] A device

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> be cancelled only by that board if re-elected, or by a board elected by a two-thirds vote (unless the certificate of incorporation so provides). The discrimination in boards, i.e., those we approve of have power, those we do not don't have the power, in the absence of a supermajority, is contrary to the statute.

Id. at 485–86.

149. See id. at 485–86. *Bank of New York* suggests that a board may have the authority to restrict future boards provided those restrictions are set forth in the certificate of incorporation. See id. at 485. The ability to restrict future boards is secured if the restrictions are detailed in the certificate of incorporation because the incumbent board would not frustrate shareholder expectations by restricting a future board's power to redeem a poison pill. In this event, shareholders could anticipate such a contingency in light of the terms of the charter. However, where such a restriction is not enumerated in the certificate of incorporation, shareholders would not expect that the power of the board could be so limited. See id.

150. See, e.g., Dynamics Corp. of Am. v. CTS Corp., 637 F. Supp. 406, 408 (N.D. Ill. 1986) ("Indiana courts generally look to Delaware decisions in matters of corporate law."), *aff'd*, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987); *Bank of N.Y.*, 528 N.Y.S. 2d at 485 (citing Delaware case law as authority for corporate issues).

151. Only a few cases discuss the existence of continuing directors provisions, and fewer still acknowledge that the provisions are problematic because of their impact on the shareholder electoral franchise. However, in no case except *Bank of New York* has a court struck a continuing directors provision. See, e.g., Grimes v. Donald, No. CIV.A.1335, 1995 WL 54441, at *11 n.5 (Del. Ch. Jan. 11, 1995) (declining to scrutinize defendant's continuing directors provision because no party sought to run a proxy contest and plaintiff did not raise any franchise implications); Sutton Holding Corp. v. Desoto, Inc., 1991 Fed. Sec. L. Rep. (CCH) ¶ 96,012, at 90,065 (Del. Ch. May 14, 1991) (concluding that "one cannot as a matter of corporation law alone say [the continuing directors provision in defendant's pension plan] is invalid"); Davis Acquisition Inc. v. NWA Inc., 1990 Fed. Sec. L. Rep. (CCH) ¶ 95,434 at 97,214 (Del. Ch. Apr. 25, 1989) (failing to determine validity of continuing directors provision in defendant's poison pill); Prime Computer, Inc. v. Allen, No. CIV.A.9557, 1988 WL 5277, at *2–5 (Del. Ch. Jan. 25, 1988) (describing continuing directors provision in defendant's poison pill but upholding shareholder's ability to commence a consent solicitation by enjoining impeding bylaws rather than invalidating the continuing directors provision).

152. For a judicial pronouncement of this claim, see *Sutton Holding Corp.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,064; Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988). The *Blasius* court summarized past Delaware decisions that have contributed to the jurisdiction's protection of the electoral franchise:

> Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights. This concern suffuses our law, manifesting itself in various settings. For example, the perceived importance of the franchise explains the cases that hold that a director's fiduciary duty requires disclosure to shareholders asked to authorize a transaction of all material information in the corporation's possession, even if the transaction is not a self-dealing one. A similar concern, for credible corporate democracy, underlies

which a board implements and designs to infringe voting rights of shareholders should be closely scrutinized by the courts pursuant to *Blasius*.[153] A court's review of any such provision should involve the application of the *Unocal* test, as is done in the review of all defenses to a control contest.[154] Under this standard, any continuing directors provision must fail to survive judicial scrutiny if the result is to be consistent with the underpinning principles of Delaware corporate law.

III. A Call for Per Se Invalidation of Continuing Directors Provisions

The proper judicial response to the continuing directors provision is per se invalidation.[155] This result guarantees shareholder rights and at the same time sustains the necessary shareholder protection that poison pills provide against coercion by raiders. A per se rule maximizes shareholder sovereignty, facilitates judicial economy, and sends a clear message to corporate governors. Furthermore, efforts to create a next-generation, judicially acceptable continuing directors provision by diluting the power of Cordis-styled provisions have no impact on the validity of

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> those cases that strike down board action that sets or moves an annual meeting date upon a finding that such action was intended to thwart a shareholder group from effectively mounting an election campaign. The cases invalidating stock issued for the primary purpose of diluting the voting power of a control block also reflect the law's concern that a credible form of corporate democracy be maintained. Similarly, a concern for corporate democracy is reflected (1) in our statutory requirement of annual meetings (8 Del. C. § 211), and in the cases that aggressively and summarily enforce that right and (2) in our consent statute (8 Del. C. § 228) and the interpretation it has been accorded.

Id. at 659–60 n.2 (citations omitted).

153. See supra Part II.B.

154. See supra text accompanying note 113; supra notes 138–139 and accompanying text. The court in Hubbard v. Hollywood Park Realty Enter., Inc., No. 11,779, 1991 WL 3151, at *9 (Del. Ch. Jan. 14, 1991), stated that "*Blasius* applies only if there has been director action intended to thwart the exercise of shareholder voting rights." In the case of a board's implementation of a continuing directors provision, the action will always be intended to thwart the electoral franchise. See infra Part III.A. Consequently such action will mandate review under *Blasius* pursuant to *Hubbard*. Since *Blasius* fails to add anything to the better developed and clearer *Unocal* test, see supra note 139, a Delaware court should therefore apply the *Unocal* test in reviewing the suspect provision.

155. Judicial adoption of a per se rule invalidating continuing directors provisions would present the same potential benefits and problems as do all bright line tests. On the benefit side, "a *per se* rule that would strike down, in equity, any board action taken for the primary purpose of interfering with the effectiveness of a corporate vote would have the advantage of relative clarity and predictability." *Blasius*, 564 A.2d at 661. Moreover, such a rule "also has the advantage of most vigorously enforcing the concept of corporate democracy." Id. And while any per se rule naturally invites the objection that "it may sweep too broadly," this concern is inapposite here. Id. Continuing directors provisions provide little, if any, benefit to shareholders and introduce the risk of substantial harm. See infra Parts III.A & III.B. Given this lack of positive attributes and the degree of risk, the per se rule will never sweep too broadly.

the per se rule since all such diluted provisions suffer from the same defects as undiluted provisions.

A. *Per Se Invalidity Maximizes Shareholder Sovereignty*

Continuing directors provisions serve no purpose that could justify the abandonment of the shareholder electoral franchise. Although incumbent boards have set forth "justifications" for continuing directors provisions, such arguments invariably lack substance. For example, an incumbent board might argue that its provision defends against a raider's coercive dealings and thus is necessary to protect shareholders.[156] Such reasoning posits that by preventing the bidder from gaining control of the board, the incumbent directors retain power to revoke the target's poison pill and thereby to impede the harmful tender offer.[157] Under this view, the board's primary purpose in using the provision against the bidder's proxy contest or consent solicitation is to defend against the coercive impact of the tender offer rather than to impede the solicitation.[158]

Judicial acceptance of such reasoning is dangerous, for it risks allowing a board to disguise its entrenchment motivation as a desire to protect the company. Such a risk might be justified if continuing directors provisions protected shareholders against bidders' coercive dealings.[159] But when shareholders are faced with a takeover attempt that utilizes a joint tender offer and voting contest, the risk of coercion by the bidder is

156. See, e.g., Defendants' Memorandum of Law in Opposition to Plaintiffs' Motions for a Preliminary Injunction at 54, Bank of N.Y. Co. v. Irving Bank Corp., 528 N.Y.S.2d 482 (Sup. Ct. 1988) (No. 05568/88). In a memorandum to the court, the defendant target company in *Bank of New York* claimed that it enacted its provision to prevent the plaintiff from effecting its "plan to squeeze out [Irving Bank] shareholders at an inadequate price." Id. The defendant further argued that "[i]n light of [the] threat and in light of the fact that the proxy contest is, in substance, a vote on [the raider's] proposed merger, the Board determined to require that the Rights could be redeemed by a new board nominated by [the raider] only if the two-thirds vote required for a merger by New York law is obtained." Id. at 54–55.

157. See supra text accompanying note 45.

158. This "justification" is particularly problematic because Delaware courts have invalidated poison pills when they interfere with proxy contests. See supra notes 108–111 and accompanying text. In Moran v. Household International, Inc., the court's first review of a poison pill, two of the reasons the court upheld the pill's validity were that "the effect [of the *Moran* pill] upon proxy contests [was] minimal," 500 A.2d 1346, 1355 (Del. 1985), and there was "little change in the governance structure as a result of the adoption of the Rights Plan," id. at 1354. But when the pill clearly disrupts the proxy contest, courts have struck down such variations. See, e.g., Sutton Holding Corp. v. Desoto, Inc., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,012 at 90,604 (Del. Ch. Apr. 25, 1989) (invalidating a pill that was triggered when shareholder receives proxies from other target shareholders); Stahl v. Apple Bancorp, Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,412 at 97,035 (Del. Ch. Aug. 9, 1990) (stating that "the side in control of the levers of power [during a voting contest could not] employ them with respect to an election to coerce its opposition to restrict its legitimate electioneering activities").

159. See supra notes 58–59 and accompanying text.

virtually nonexistent.[160] In that case, shareholders would not vote for the dissident unless they freely support its agenda.

One reason shareholders would not elect an insurgent espousing an agenda inconsistent with their own is that they do not face the prisoner's dilemma confronting shareholders during a two-tiered tender offer. As discussed above, such tender offers are coercive because shareholders who refuse to tender their shares risk receiving a lower payment at the back end of the transaction when they are frozen out.[161] In contrast, shareholders voting against a dissident's slate of directors face no detrimental consequences. Proxy fights and consent solicitations do not expose shareholders to the coercive forces poison pills were designed to mitigate.

A second reason shareholders are protected is that there is no risk that a shareholder who does not support a tender offer will, through his or her ignorance or the insurgent's deception, vote for an insurgent who plans to commence a tender offer. Federal rules governing proxy solicitations mandate that solicitors fully disclose all material information related to their solicitations.[162] Since information regarding the intent to effect a tender offer would be considered material pursuant to these rules, the information must be disclosed in a proxy statement filed with the Securities and Exchange Commission.[163] Nondisclosure of the dissident's merger plans is thus precluded by federal securities regulation, and shareholders will be alerted to the dissident's takeover plans.

Moreover, continuing directors provisions should be prohibited because other means of defense that do not infringe the shareholders' franchise are available. For example, the company could amend its certificate of incorporation or bylaws to permit a classified board.[164] Other defensive techniques include requiring cause for the removal of directors,[165] fixing the maximum number of directors,[166] and requiring a supermajority vote to amend any of these changes.[167]

While, according to some commentators, "incumbents should have the burden of persuading the court that tangible benefits conferred upon shareholders justify the negative impact of defensive tactics,"[168] this ap-

160. In fact, in such a case, the source of coercion is the board of directors, which uses its "corporate power to seek to coerce shareholders in the exercise of the vote." *Sutton Holding Corp.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,064.

161. See supra Part I.B.1.

162. See 17 C.F.R. § 240.14(a)-101 Item 14 (1995).

163. See id. (requiring proxy statement to include information relating to any "merger or consolidation of the registrant into or with any other person . . . , [any] acquisition by the registrant . . . or the liquidation or dissolution of the registrant").

164. See 1 Fleischer & Sussman, supra note 2, § 6.05[A], at 6-24 to 6-28.

165. See 1 id. § 6.05[B], at 6-28 to 6-30.

166. See 1 id. § 6.05[A], at 6-26.

167. See 1 id. § 6.07, at 6-44 to 6-48.

168. Thomas, supra note 21, at 507. This requirement restates the standard of review set forth in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985), for

proach is too lenient when applied to continuing directors provisions. Because voting contests are not coercive, the implementation of continuing directors provisions provides no extra protection against the coercive aspects of takeovers. While there is no positive effect, there is an extremely negative one: continuing directors provisions infringe the shareholder electoral franchise and discourage takeovers that may be advantageous to shareholders.

The per se rule rejecting such a provision thus maximizes shareholders' legitimate rights as owners of the corporation. Because the right of the board to act derives from shareholder approval, no board action—including resistance to its own removal—is justifiable if the shareholders no longer approve of the board.[169] Courts should enjoin the application of any such provision. If courts refuse to adopt the per se rule and instead allow the continuing directors provision to stand, they will appear to sanction incumbent board entrenchment which provides no benefit in terms of shareholder protection from raider coercion.

B. *Continuing Directors Provisions Fail the* Unocal *Test*

Prevailing jurisprudence joins these important policy considerations in support of a per se rule against continuing directors provisions. In *Sinclair Oil Corp. v. Levien*, Delaware's high court articulated its rationale for the business judgment rule, stating that the judiciary should not substitute its own view relating to a board's action for that of the board itself where the action may be "attributed to any rational business purpose."[170] However, a board's implementation of defensive measures is subject to greater scrutiny.[171] A defensive action falls within the ambit of the business judgment rule only if it first satisfies the *Unocal* standard.[172] Continuing directors provisions clearly fail this test.

1. *Prong One of* Unocal. — Continuing directors provisions fail the first prong of *Unocal*, which requires a board to demonstrate reasonable grounds for believing that a danger to the company exists.[173] In takeover contests, incumbent boards typically identify a number of potential sources of harm to satisfy this first prong. A board may argue that the structure of an insurgent's offer is coercive—as in the case of a two-tiered

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scrutinizing a board's defensive actions. For an explanation of this standard, see supra notes 112–116 and accompanying text.

169. See supra Part II.B.

170. 280 A.2d 717, 720 (Del. 1971). In determining the standards which measure a board's action, "the business judgment rule . . . is applicable in the context of a takeover." *Unocal*, 493 A.2d at 954. For a definition of the business judgment rule, see supra note 90.

171. See Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 (Del. 1994) (stating that defensive measures are subject to enhanced scrutiny); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1989) (stating "this Court will continue to exact an enhanced judicial scrutiny at the threshold, as in *Unocal*, before the normal presumption of the business judgment rule will apply").

172. See supra notes 112–116 and accompanying text.

173. See *Unocal*, 493 A.2d at 955; supra text accompanying note 114.

tender offer.[174] In addition, explaining that "the present stock market price of shares is not representative of [the target's] true value," a board may contend that the insurgent's tender offer price is inadequate.[175] Furthermore, a board may assert that the shareholders' acceptance of the insurgent's offer would preclude them from benefitting from a superior business plan that the board proposes.[176] However, despite these assertions, where the insurgent commences a proxy contest or consent solicitation, the true threat against which the incumbent board fights is its own replacement with directors supported by the insurgent.

The *Unocal* court listed a number of hypothetical threats that would potentially justify a board's defensive maneuvers.[177] However, nowhere does the court suggest that placing new directors on the board or replacing incumbents with new directors constitutes a threat. While the court's list may not exhaust all qualifying sources of harm, the threats enumerated are substantially different from those against which a continuing directors provision protects during a proxy fight or consent solicitation. The listed threats involve issues of fairness to the shareholders and other constituencies; they do not implicate concerns of directorial job loss or control changes.[178] Thus, the replacement of the incumbent board should not qualify as a threat within the meaning of *Unocal.*

The showing required by *Unocal*'s first prong derives from the directors' duty of care to protect the corporation and its shareholders from potential harm arising from a perceived threat. However, powers stemming from this duty are not absolute, as directors face limits on the extent to which they may exercise power to protect the company and its owners.[179] One such limit is that the directors may not act "solely or primarily out of a desire to perpetuate themselves in office."[180] An incumbent board's implementation of a continuing directors provision violates this limitation because, as the court stated in *Sutton Holding Corp. v. Desoto,*

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174. See Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989).

175. Id. at 1150 n.12.

176. See id at 1153.

177. These threats include "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange." *Unocal,* 493 A.2d at 955. In addition, the court suggested that some less significant concerns might be considered: "While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor." Id. at 955–56.

178. This is particularly true given Delaware's and other jurisdictions' vehement protection of shareholder voting rights. See supra Part II.B.

179. See *Unocal,* 493 A.2d at 955 ("A corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available.").

180. Id.; see also supra text accompanying note 142 for a discussion of the business judgment rule in the shareholder voting context.

Inc., such provisions "are designed to deter a change in control[,] not to create useful rights in the event they are triggered."[181] The board, acting to entrench its own position, oversteps the limits of its power to protect the company. A board's implementation of a continuing directors provision would thus fail the first prong of the *Unocal* test.

2. *Prong Two of* Unocal. — Continuing directors provisions also fail *Unocal*'s second prong. Under this second step, for a defensive move to fall "within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed."[182] This analysis requires the directors to consider the "nature of the takeover bid and its effect on the corporate enterprise" when balancing the potential harm of the pending takeover against that of the defensive action taken by the board.[183] If the board satisfies this balancing test, the business judgment rule will protect the board's decisions. If not, the court will invalidate the board's defensive strategy.

Continuing directors provisions fail the balancing test imposed by *Unocal*'s second prong. The purported "threat" posed by a proxy or consent solicitation carries little weight when balanced against the harm a defensive provision causes by stripping shareholders of their legitimate voting rights. Although a control change in the target corporation might allow a bidder to redeem the poison pill that protects against a coercive tender offer, any concern of coercion is unfounded because the shareholders would not replace the board absent willing support for the tender offer.[184] The threat posed by a voting contest for the election of directors is thus insufficiently harmful to justify implementing defensive measures that infringe the electoral franchise.

In fact, a board's implementation of a continuing directors provision qualifies as a draconian action, and thus is forbidden under the rule of *Unitrin*.[185] As discussed above, by preventing a bidder from replacing the incumbent board and redeeming the target's poison pill, continuing directors provisions effectively block any unsolicited takeover bids.[186] Furthermore, by foreclosing the possibility of a merger transaction that shareholders favor unless the incumbents are reelected, continuing directors provisions coerce shareholders into supporting the incumbent board.[187] The *Unitrin* court identified as draconian any action that precludes an insurgent shareholder from gaining control of a target or that coerces shareholders into accepting a management-sponsored agenda.[188] A continuing directors provision's preclusive and coercive characteristics

181. 1991 Fed. Sec. L. Rep. (CCH) ¶ 96,012 at 90,064 (Del. Ch. May 14, 1991).

182. *Unocal*, 493 A.2d at 955.

183. Id.

184. See supra notes 160–163 and accompanying text.

185. See Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1387 (Del. 1995).

186. See supra notes 86–88 and accompanying text.

187. See supra note 88 and accompanying text.

188. See *Unitrin*, 651 A.2d at 1387; supra note 133 and accompanying text.

thus qualify as draconian and consequently beyond the "range of reasonableness" mandated by *Unitrin*. Continuing directors provisions clearly fail the second prong of the *Unocal* test, and should be deemed invalid by the courts.

C. *"Diluted" Continuing Directors Provisions*

Continuing directors provisions, such as the one enacted by Cordis Corporation to defend against J&J's control contest,[189] prohibit newly elected board members who do not qualify as continuing directors from redeeming the company's poison pill for the duration of the pill's life.[190] As discussed above, Cordis-styled continuing directors provisions are clearly invalid because they disenfranchise shareholders[191] and because boards breach their fiduciary duties when they enact such provisions.[192] But companies have taken other approaches that attempt to correct these illegal characteristics.[193] Such companies have revised the provisions to include an opportunity, in certain circumstances, for a board not consisting of continuing directors to redeem the rights before the expiration of the pill.[194] However, efforts to create a judicially acceptable continuing directors provision by diluting the power of Cordis-styled provisions do not amount to an acceptable alternative to the per se rule, since all such diluted provisions suffer from the same defects as undiluted provisions.[195]

1. *Supermajority Override Clause.* — One example of a diluted continuing directors provision contains a clause that provides for some measure of shareholder participation in determining whether the provision would strip newly-elected, noncontinuing directors of their power to redeem

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189. See supra notes 7–13.

190. See supra note 88.

191. See supra Part III.A.

192. See supra Part III.B.

193. Fleischer & Sussman state that these new varieties were

> designed to strike a balance between two potentially competing stockholder interests: their interest in being protected by the beneficial effects of the pill, despite the absence of charter provisions to inhibit a raider's self-interested use of the corporate machinery; and their interest in being able to elect a board of their choice, which the courts have recognized as one of the aspects of their fundamental franchise right.

1 Fleischer & Sussman, supra note 2, § 5.05[6], at 5-91 (footnote omitted).

194. Any number of such provisions may exist. This Note examines two of the most prevalent forms of revised continuing directors provisions—a provision containing a supermajority override clause and a delayed redemption provision—but the number of such revised provisions is limited only by one's imagination. For example, a target company might enact a provision that applies to all but all-cash, all-shares tender offers. Despite such creative developments, a valid provision has yet to be enacted.

195. This Note refers to these revised varieties of continuing directors provisions as "diluted" or "watered-down" provisions because, as described below, the terms of such provisions are less preclusive or coercive than a "pure" provision such as Cordis's.

the company's poison pill.[196] Pursuant to such a clause, a supermajority vote of (usually) two-thirds of eligible votes cast in favor of any noncontinuing director would override the continuing directors provision and restore full directorial power to the director.[197] Upon the successful completion of such a vote, a newly elected board would be empowered to redeem the pill, despite the provision's initial prohibition of such action.

As discussed above, this variety of continuing directors provision has already been held illegal on statutory grounds under New York law[198] and most likely would be invalid under Delaware law for similar reasons.[199] However, criticisms of a provision containing such a clause need not be confined to its statutory violations. These provisions also infringe the shareholder electoral franchise and are contrary to the fiduciary duties of the board enacting the clause.[200]

The relationship between the stockholder and the managers of the corporation is often described as a contractual one, where the stockholder agrees to provide capital and the managers agree to maximize wealth.[201] The terms of this contract are spelled out in the corporation's certificate of incorporation and bylaws, in state and federal common law, and in state and federal statutory provisions. Where the certificate of incorporation provides that a majority vote is required to elect directors, for example, shareholders agree to provide capital on the condition that if they acquire fifty-one percent of the company's stock, they will be able to elect a board empowered to take all action permitted by law. The imple-

196. See, e.g., Bank of N. Y. Co. v. Irving Bank Corp., 528 N.Y.S.2d 482, 483 (Sup. Ct. 1988) (citing the terms of Irving Bank Corporation's poison pill). Irving Bank's continuing directors provision included a clause that empowered members of the board of directors who were not continuing directors to redeem the pill if such members "were elected by the affirmative vote of the holders of at least two-thirds of the issued and outstanding [s]hares" of the company. Id.

197. See id.

198. See supra text accompanying notes 144–149.

199. See supra note 145.

200. In a brief filed in connection with the *Bank of New York* case, the plaintiff described the coercive effects of Irving Bank's continuing directors provision—which contained a supermajority override clause—on the shareholder voting franchise:

> While the possibility exists that the [Bank of New York (BNY)] slate could be elected by a two-thirds vote, shareholders will recognize a risk that the BNY slate might be elected by less than two-thirds vote and therefore the Rights could *never* be redeemed by any board. This would adversely affect the prospect for any future takeover or merger, whether by BNY or anyone else. To protect against such a draconian result, even shareholders who prefer the BNY slate might feel compelled to vote for the incumbent board.

Plaintiffs' Reply Memorandum in Support of Their Motion for a Preliminary Injunction at 8, Swiskay v. Irving Bank Corp. (No. 24119/87) (N.Y. Sup. Ct. 1988).

201. See Lucian A. Bebchuck, Foreward: The Debate On Contractual Freedom in Corporate Law, 89 Colum. L. Rev. 1395, 1397 (1989); Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians, 65 Wash. L. Rev. 1, 7 (1990); Daniel R. Fischel, The Corporate Governance Movement, 35 Vand. L. Rev. 1259, 1262 (1982).

mentation of a clause requiring a two-thirds vote before the shareholder may elect a fully empowered director represents a breach of the incumbent board's contract with the shareholders. In this scenario, the shareholders are deprived of the electoral right for which they bargained.[202] Furthermore, because fiduciary duties include those obligations required by the contract, the board breaches its fiduciary duties when it breaks the contract.[203] Thus, shareholder voting rights are infringed and the incumbent directors breach their fiduciary duties when they enact a supermajority override clause.

2. *Deferred Redemption Provision.* — A second example of a diluted continuing directors provision is a device, often referred to as a "deferred redemption provision,"[204] that prohibits a newly-elected board of non-continuing directors from redeeming the target's pill for a fixed period of time, such as 180 days, after its election.[205] Such a provision suffers from the same flaw that renders Cordis-styled continuing directors provisions invalid: it penalizes target shareholders for exercising their right to

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202. However, it must be noted that the shareholders have not been entirely deprived of their rights to elect a fully empowered director, as they are under Cordis-styled continuing directors provisions.

203. Fischel describes the relationship of fiduciary duties to the rights and obligations of shareholders and managers:

> The imposition by the law of fiduciary duties serves as an alternative or a supplement to . . . writing lengthy and complicated contracts. Optimal fiduciary duties should approximate the bargain that investors and managers would reach if transaction costs were zero. Thus fiduciary duties . . . constrain the actions of managers in the situations in which conflicts of interest are likely to arise. Fiduciary duties serve, in other words, as a standard form contractual term in every agency contract.

Fischel, supra note 201, at 1264 (footnote omitted).

204. See Davis Acquisition Inc. v. NWA Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,434 at 97,210 (Del. Ch. Apr. 25, 1989).

205. Fleischer & Sussman describe the deferred redemption provision at issue in *Davis Acquisition Inc.*:

> The effect of the provision was that, for 180 days following the election [of a new board], the rights could not be redeemed if redemption was reasonably likely to have the purpose or effect of facilitating a transaction [which would trigger the pill and if the party triggering the pill] directly or indirectly proposed or nominated any of the new directors.

1 Fleischer & Sussman, supra note 2, § 5.05[F], at 5-90. Commercial Intertech Corporation (CIC) adopted a similar provision:

> CIC's Poison Pill Plan provides that, while the current CIC Board of Directors may designate a tender offer for all shares to be a "Permitted Offer" not subject to the Plan, *no* offer—regardless of its merits, its price, or its terms—may be deemed a Permitted Offer for a period of 180 days following the election to the majority of the Board of Directors of CIC of persons not nominated by the incumbent Directors.

Verified Complaint for Temporary Restraining Order and for Preliminary and Permanent Injunctive Relief and Declaratory Judgment at ¶ 56, United Dominion Indus. Ltd. v. Commercial Intertech Corp. (filed in S.D. Ohio) (No. C2-96-672) [hereinafter Verified Complaint].

oust the incumbent board and replace it with one that favors the tender offer.[206]

The fact that the period during which the new directors are unable to redeem the pill is shortened to 180 days neither mitigates the preclusive impact the provision exerts during the time the provision is in effect nor ameliorates the coercion exerted on shareholders electing a board that supports the target's participation in a merger or acquisition transaction. For such shareholders, the decision to vote for the new slate of directors would be "chilled" if immediate execution of the desired transaction were not possible.[207] Thus, this diluted provision, as well, does

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206. See id. ¶ 55.

207. See 1 Fleischer & Sussman, supra note 2, § 5.05[F], at 5-90. Seeking the invalidation of defendant NWA Inc.'s deferred redemption provision, Davis Acquisition Inc., a plaintiff in *Davis Acquisition Inc.*, convincingly argued this same point. The court summarized Davis's position:

> [S]hareholders are actively discouraged by the Delayed Redemption Provision from voting for the Davis slate of directors, since a board comprised predominately of such persons would have less corporate power than the incumbent board's slate. The distinction in corporate power is material in these circumstances . . . . The Davis slate of directors will run on a "platform" that promises that if elected, they will promptly cause the sale of [NWA Inc.] at the highest available price. The constituency that could be expected to embrace this platform most warmly . . . is obviously those who seek a prompt sale. But such shareholders will be chilled . . . from voting for the Davis slate since it, but not the management slate, cannot authorize a prompt Davis transaction.

Davis Acquisition Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,211. Although the court made no determination with respect to this issue, it admitted to being "unimpressed" by Davis's contention, explaining that there is a difference between "the intention of the defendants to coerce the NWA shareholders" and the intention "to discourage [Davis] from conducting a proxy contest or a consent solicitation." Id. at 97,213 & n.2.

The court's conclusion suffers for two reasons. First, these aims are closely related, as the court itself appears to recognize. See id. at 97,213 n.2. Both aims are part of the same act: an attempt by the board to interfere with the effectiveness of the target's electoral machinery. The incumbent board wanted to prevent Davis from running a proxy contest in order to prevent the shareholders from voting for the Davis slate. The "distinction" the court drew in its explanation disregards this meaningful connection and is therefore false. Second, the court's focus on the *intention* of the board, rather than on the *effect* of its actions, is misplaced. The court in *Packer v. Yampol* emphasized the significance of the effect, rather than intent, in the analysis of a board's action:

> As a legal matter, even if the defendants were found not to have subjectively intended to obstruct the plaintiffs' effort to wage a proxy contest, it would make no difference in this case. An inequitable purpose can be inferred where the directors' conduct has the effect of being unnecessary under the circumstances, of thwarting shareholder opposition, and of perpetuating management in office.

12 Del. J. Corp. L. 332, 358 (Del. Ch. April 18, 1986).

As the court in *Aprahamian v. HBO & Co.* concluded, "[t]he corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates." 531 A.2d 1204, 1206 (Del. Ch. 1987); see also Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988) (citing this passage from *Aprahamian* with approval). The effect of NWA Inc.'s deferred redemption provision was to coerce shareholders into supporting the

little to correct the shortcomings of the Cordis variety of continuing directors provision.

3. *Summary of the Validity of Diluted Provisions.* — In short, corporations' attempts to develop a continuing directors provision that falls within the boundaries of a permissible defensive mechanism by diluting the terms of Cordis-styled provisions have failed. Although diluted continuing directors provisions soften the harsh impact of Cordis-styled provisions, the diluted varieties are still unacceptably harmful to shareholders. Enactment of these diluted provisions continues to deprive shareholders of their voting rights and, given the preclusive and coercive characteristics, continues to constitute a breach of the directors' fiduciary duties.

Conclusion

When continuing directors provisions are employed to defend against takeover contests, the principal purpose of the directors implementing the provisions is to preserve their incumbent positions. Moreover, continuing directors provisions increase the risk of board entrenchment while failing to provide any additional shareholder protection against coercive moves by bidders. For these reasons, the provisions interfere with the the shareholder vote and are of little utility in protecting shareholders against coercion in proxy or consent solicitations. Under the *Blasius* reasoning, therefore, such continuing directors provisions must be reviewed.

Scrutiny of any such provision must result in invalidation, as the provisions necessarily fail the *Unocal* test.[208] Under the test's first prong, the risk that shareholders will vote out incumbent directors does not qualify as a "threat." Under the test's second prong, continuing directors provisions are an unreasonable defense in relation to the threat posed. Thus, continuing directors provisions in poison pills should be found per se invalid on the ground that they serve no purpose but to entrench management and consequently infringe shareholder sovereignty. This finding would enhance the shareholder voting franchise and would prevent a misallocation of control between the board of directors and shareholders.

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incumbent slate of directors. The provision thus conferred a substantial advantage to the incumbent slate and actually disadvantaged the Davis slate. Regardless of the board's intent, its enactment of the provision was unfair and is therefore invalid under *Aprahamian*. See 531 A.2d at 1206–07.

208. See supra Part III.B.